
Cloaked in Uncertainty: Treatment of "Stub Rent" in the Goody's and Stone Barn Retail Apparel Bankruptcies

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Two recent decisions in retail apparel bankruptcy cases, in Delaware and New York, highlight the ongoing uncertainty regarding "stub rent".* The two cases—*Goody's*¹ and *Stone Barn/Steve & Barry's*²—involved nearly identical facts, yet the courts adopted different approaches for the mechanisms available for landlords to collect "stub rent" from tenants in bankruptcy. While the ultimate financial outcomes for the landlords in the two cases are similar, the different approaches taken by the courts leave open questions regarding when and to what extent those claims will be paid.

When "Stub Rent" Claims Arise

A landlord's claim against a bankrupt tenant for "stub rent" arises when the lease calls for payment of rent in advance, *i.e.* the first of the month. If the tenant files its bankruptcy case later in the month without having paid that month's rent, the bankruptcy filing can be said to divide the monthly rent into two portions—first, the portion allocable to the days of the month before the bankruptcy filing, and second, the portion allocable to the days of the month remaining after the bankruptcy filing. The term "stub rent" refers to the amount of rent due under the lease for the second, or stub, period. When a tenant files for bankruptcy, landlords may assert a claim under Section 365(d)(3) of the Bankruptcy Code³ for immediate payment of the "stub rent".

Two Approaches to Addressing "Stub Rent" Claims Under Section 365(d)(3)

The decisions in *Goody's* and *Stone Barn* illustrate the two main approaches courts have adopted for dealing with "stub rent" under Section 365(d)(3):⁴

- **"Billing Date" Approach.** The "billing date" approach, often preferred by tenants,⁵ focuses on when the rent is due, usually prior to the petition date. Under the "billing date" approach, if the rent is due on the first of the month and the tenant files bankruptcy later in the month, none of the rent is considered a post-petition obligation subject to payment under Section 365(d)(3). Thus, under the "billing date" approach, there is no Section 365(d)(3) claim for "stub rent."⁶

- **"Proration" Approach.** The "proration" approach, often preferred by landlords, provides that the obligation to pay the month's rent should be allocated on a per diem basis to each day within the month, such that a bankruptcy filing on the fifteenth day of the month would create a "stub rent" claim for the second half of the month. Under the "proration" approach, there is a Section 365(d)(3) claim for immediate payment of rent allocable to the stub period.

"Back-up" Claims for "Stub Rent" under Section 503(b)(1)

When a court applies the "billing date" approach for purposes of Section 365(d)(3), the decision in *Goody's* instructs that landlords may nevertheless be entitled to payment of rent for the stub period under section 503(b)(1). Section 503(b)(1) provides an administrative expense claim for "the actual, necessary costs and expenses of preserving the estate."⁷ Administrative expenses ordinarily must be paid in a successful Chapter 11 bankruptcy case, but are generally not required to be paid until a Chapter 11 plan is confirmed and effective—by contrast, Section 365(d)(3) expressly requires "stub rent" to be paid on a "timely" basis, which is usually interpreted to mean immediately as it becomes due. As such, a Section 503(b)(1) claim may serve as a "back-up" for a landlord in the event that a Section 365(d)(3) claim is denied, although Section 503(b)(1) may pose additional hurdles to a landlord (discussed further below) and will result in later and perhaps more uncertain payment if a Chapter 11 plan of reorganization is delayed or at risk of failure.

The Recent Decisions in *Goody's* and *Stone Barn*

The pertinent facts in *Goody's* and *Stone Barn* are nearly identical. The tenants in each case, apparel retailers, filed voluntary Chapter 11 petitions on the ninth day of the applicable months. At the time of filing, none of the debtors had paid the rent due on the first of the month under their retail location leases, yet they continued to occupy the leased space to conduct retail sales.

In re Goody's Family Clothing, Inc.

The March 31, 2009 decision in *Goody's*, by the United States District Court for the District of Delaware, resulted from an appeal of a decision from the Delaware Bankruptcy Court. The Bankruptcy Court, relying on precedent from the United States Court of Appeals for the Third Circuit in the *Montgomery Ward*⁸ case, summarily disposed of the landlords' argument for adoption of the "proration" approach. Instead, the Delaware Bankruptcy Court held that the plain meaning of Section 365(d)(3) commanded use of the "billing date" approach for "stub rent." The court interpreted the term "obligations" as used in Section 365(d)(3) to mean "something that one is legally required to perform under the terms of the lease."⁹ The court went on to conclude that an obligation only arises when a party becomes legally obligated to perform it. Because the debtors' obligations to pay rent under the leases were due on the first of the month (about a week before the petition date), they could not be said to have arisen "after the order for relief" and, therefore, the landlords were not entitled to payment of "stub rent" under Section 365(d)(3).

The Delaware Bankruptcy Court rejected, however, the debtors' argument that Section 365(d)(3) renders Section 503(b)(1) inapplicable, holding that (1) the debtors' occupancy of the premises alone was sufficient to establish that payment for such occupancy was an actual and necessary expense of preserving the debtors' estates, and (2) absent evidence to the contrary, the fair market value of occupying the premises was the lease rate. The court did not, however, order immediate payment of the administrative expense claim, a ruling emphasizing that a Section 503(b)(1) claim may be only a second-best result for landlords.

The debtors appealed the Bankruptcy Court's holding that Section 503(b)(1) was available to landlords seeking "stub rent" after the enactment of Section 365(d)(3), as well as the Bankruptcy Court's holding that the debtors' mere presence in the property was sufficient to satisfy the landlords' burden under Section 503(b)(1).¹⁰ The landlords did not cross-appeal.

Because the parties to the appeal did not dispute the Delaware Bankruptcy Court's application of the "billing date" approach, the Delaware District Court declined to revisit the lower court's ruling on that issue. The Delaware District Court went to substantial lengths, however, to explain that if it had reached the issue, it might have read *Montgomery Ward* more narrowly than did the Delaware Bankruptcy Court. The District Court, in an extended footnote, explained its basis for why a Section 365(d)(3) "proration" approach might apply to "stub rent" notwithstanding the Third Circuit Court of Appeals precedent adopting the "billing date" approach for tax claims. Given that the purpose of Section 365(d)(3) was to free landlords from having to comply with the administrative expense procedure, the District Court found it "a perverse result that debtor-tenants could use § 365(d)(3) offensively to avoid timely rent payments."¹¹ Moreover, the District Court found problematic the idea that the impact of Section 365(d)(3) would depend on a landlord's lease-drafting choices, *i.e.* under the "billing date" approach, a lease requiring that rent be due in full on the first day of the month deprives Section 365(d)(3) of any practical effect, whereas a lease requiring that rent be due each day would presumably lead to payment for the stub period under Section 365(d)(3).

The Delaware District Court proposed three ways of reconciling the Third Circuit's apparent rejection of the "proration" approach for tax claims in *Montgomery Ward* with the legislative intent for rent claims underlying Section 365(d)(3). First, the District Court noted that rent could be viewed as an obligation that "arises" in full each day of a tenant's occupancy. The result would be that a tenant who files for bankruptcy after the first of the month still owes rent for the full month (not a prorated portion) under Section 365(d)(3). However, the District Court did not explain how this would provide a basis for distinguishing the treatment of rent claims from the treatment of tax claims. Second, the District Court reasoned that if a lease provides a grace period for payment that expires post-petition, it could be argued that the payment obligation has arisen post-petition under Section 365(d)(3). Of course, this might only shift the timing of a debtor's bankruptcy filing to several days later in the month, after any applicable grace period expires, rather than result in a dramatic change in treatment of "stub rent."¹² Third, if a lease provides for a default penalty that accrues during the post-petition/pre-rejection period, "one might interpret the lease as creating a new obligation to which § 365(d)(3) would apply, namely, payment of the complete delinquent rent plus the penalty."¹³

After a lengthy analysis, the Delaware District Court affirmed the Bankruptcy Court's conclusion that Section 365(d)(3) does not render Section 503(b)(1) inapplicable, holding that "[n]othing within the text of § 365, the legislative history, or other canons of interpretation, bars the collection of post-petition rent through the administrative expense procedure of § 503(b)(1)."¹⁴ Applying Section 503(b)(1), the Delaware District Court held that the debtors' use of the premises to conduct normal business and rental of the premises to a liquidator to conduct profitable store closing sales was sufficient to establish the necessity of the debtors' use of the premises. The court noted that although there was no ambiguity in this case as to whether the debtors genuinely occupied and used the premises, "[h]ad the [debtors] vacated, or merely left idle the premises—a "lights out" lease—the landlords] would be faced with a more difficult claim."¹⁵

In re Stone Barn Manhattan LLC

The court in *Stone Barn* did not require the landlords to follow as circuitous a path as the *Goody's* court to pursue "stub rent". The United States Bankruptcy Court for the Southern District of New York concluded that holding the debtor immediately responsible for "stub rent", measured on a daily basis as it accrued after the date of the order for relief until the end of that month, was the proper construction of Section 365(d)(3). The court reasoned that the "proration" approach is faithful to the purpose of Section 365(d)(3) because it "afford[s] landlords an enhanced right to timely performance under a commercial lease during [the post-petition, pre-rejection period]" and is faithful to the "purpose of the bankruptcy laws as a whole."¹⁶

The court noted that although a number of bankruptcy courts have eschewed the "proration" method, "very few of these courts have been willing to draw the obvious conclusion that rent for the first month is a pre-petition claim only, based on the "billing date" approach, and that the debtor has the right to use the leased property during the stub period without further liability."¹⁷ Instead, these courts fill the gap by allowing landlords an administrative claim for rent under Section 503(b). Indeed, that was the result in *Goody's*. Thus, the New York Bankruptcy Court implied that the "proration" approach under Section 365(d)(3) is a more straightforward mechanism of reaching a result that would likely be the same under Section 503(b)(1).

The court emphasized that Congress intended Section 365(d)(3) to nullify the requirement that a creditor prove benefit to the estate before it can obtain administrative expense status for a post-petition rent claim. Under the "billing date" approach, the landlords would have to prove, in order to prevail on a Section 503(b)(1) claim, that a debtor's use and occupancy was necessary and beneficial to the estate during the stub period. Therefore, the court reasoned that the "billing date" approach contradicts the plain purpose of Section 365(d)(3)—to give landlords an irrefutable right to rent at the contract rate during the bankruptcy. Still, the New York Bankruptcy Court noted that this is an issue on which different courts have come to different conclusions, and that its decision therefore may be an appropriate candidate for appeal to higher courts in the Second Circuit.

The Bottom Line

The contrast of *Goody's* and *Stone Barn* demonstrates the different approaches that courts may take to the stub rent issue under Section 365(d)(3). However, these different approaches are not polar opposites. Rather, the Delaware District Court's decision indicates a possible movement in the Third Circuit, which is a traditionally "billing date" jurisdiction, toward the "proration" approach used in New York. Moreover, the Delaware District Court's relatively brief treatment of the "actual" and "necessary" elements of the landlords' Section 503(b)(1) claims makes the Section 503(b)(1) process in Delaware appear very similar to the Section 365(d)(3) process in New York. Even assuming the Third Circuit retains the "billing date" approach for "stub rent," the primary disadvantage of that approach for landlords may be the timing and certainty of payment in a case where a Chapter 11 plan or reorganization is delayed or at risk of administrative insolvency.

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¹ The U.S. District Court for the District of Delaware, in *In re Goody's Family Clothing, Inc.*, No. 08-585 (D. Del. March 31, 2009), recently affirmed, in a lengthy opinion, the Bankruptcy Court's ruling in that case, 392 B.R. 604 (Bankr. D. Del. 2008).

² *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008). "Stone Barn" is often referred to by the trade name "Steve & Barry's."

³ 11 U.S.C. § 365(d)(3). Section 365(d)(3) provides, in relevant part, that "the trustee shall timely perform all obligations of the debtor...arising from and after the order for relief under any expired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title." 11 U.S.C. § 365(d)(3).

⁴ Courts have disagreed on which approach to adopt with respect to the treatment of a debtor's post-petition lease obligations under Section 365(d)(3). Compare *In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998), *In re Furr's Supermarkets, Inc.*, 283 B.R. 60 (B.A.P. 10th Cir. 2002), and *In re All For a Dollar, Inc.*, 174 B.R. 358 (Bankr. D. Mass. 1994) (applying "proration" approach), with *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986 (6th Cir. 2000), and *HA-LO Industries v. CenterPoint Properties Trust*, 342 F.3d 794 (7th Cir. 2003) (applying "billing date" approach).

⁵ There are instances where a landlord may benefit from the billing date approach, for example, in the context of annual taxes that become due in arrears under a lease following the bankruptcy filing date. See *infra* note 8.

⁶ The "billing date" approach is alternatively labeled the "performance" approach.

⁷ 11 U.S.C. § 503(b)(1).

⁸ *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001). The Third Circuit in

Montgomery Ward held that where a lease obligates a debtor to pay a tax bill upon receipt and the bill is received post-petition for taxes allocable to both pre-petition and post-petition periods, the entirety of the tax payment must be made in a timely manner under Section 365(d)(3). Significantly, as described below, in footnote 8 of its *Goody's* decision the Delaware District Court indicated that *Montgomery Ward's* ruling on tax claims may not be binding precedent with respect to "stub rent" claims, reviving the possibility of a "proration" approach to "stub rent" claims in Delaware and elsewhere in the Third Circuit.

⁹*In re Goody's Family Clothing, Inc.*, 392 B.R. 604, 609 (Bankr. D. Del. 2008).

¹⁰ The debtors appealed multiple Bankruptcy Court orders granting landlords administrative claims for "stub rent". While some of the appeals were consolidated and dealt with by the Delaware District Court's opinion, others remain pending. In addition, the debtors have indicated in filings with the Bankruptcy Court their intention to appeal future orders granting landlords' administrative claims under Section 503(b)(1). The legal issues raised in the pending and possible future appeals will likely be disposed of, under the doctrine of collateral estoppel, by reference to the District Court's recent decision. The factual issues of whether the debtors' occupancy was necessary to the preservation of the estate, however, may need to be decided on a case-by-case basis. The need for such fact specific inquiry under Section 503(b)(1) highlights the consequence to landlords of the court's declining to adopt the "proration" approach.

¹¹*Goody's*, No. 08-585, slip. op. at 12 n.8.

¹² Nevertheless, a landlord may be able to take other actions to structure lease obligations in a way that mitigates the effect of the "billing date" approach. For example, a landlord could require monthly payment in advance toward annual taxes due at year end.

¹³*Id.* (emphasis in original).

¹⁴*Id.* at 25.

¹⁵*Id.* at 33. Not only must a landlord satisfy the burdens of proof imposed by Section 503(b)(1), but a landlord asserting a Section 503(b)(1) administrative claim may be denied the benefit of its lease bargain if prevailing rental rates change so that the fair market rental value of the premises drops below the originally bargained-for rent—not an uncommon occurrence in a declining real estate market. *In re Ames Dept. Stores, Inc.*, 306 B.R. 43, 68 (Bankr. S.D.N.Y. 2004). Although not as common, the converse is also possible where a landlord can establish that the fair market rental value of the premises is greater than the lease rate. See *In re Xonics, Inc.*, 65 B.R. 69, 74 (Bankr. N.D. Ill. 1986). While the Delaware District Court in the *Goody's* case did not press the landlords to prove the "actual" and "necessary" elements of their Section 503(b)(1) claims (indeed, the District Court declined to remand to the Bankruptcy Court for further consideration of those elements), relying on the debtors' use of the leased premises as *prima facie* evidence of those elements, other courts or other facts may require further proof of those elements.

¹⁶*Stone Barn*, 398 B.R. at 365-66.

¹⁷*Id.* at 366.

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