

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

## The Ticket to Solving the Stub Rent Dilemma

Written by:

Joel H. Levitin

Cahill Gordon & Reindel LLP; New York  
jlevitin@cahill.com

Richard A. Stieglitz Jr.

Cahill Gordon & Reindel LLP; New York<sup>1</sup>  
rstieglitz@cahill.com

The Stone Barn Manhattan LLC (fka Steve & Barry's Manhattan LLC) bankruptcy case<sup>2</sup> recently decided by the U.S. Bankruptcy Court for the Southern District of New York provides a sensible solution resolving the split of authority on how a debtor must prorate rent for the month it files for bankruptcy protection. The split of authority results from ambiguity in Bankruptcy Code §365(d)(3) on how to handle the typical situation in which a lessee files for bankruptcy protection in the middle of the month under a lease that calls for payment of rent on the first day of the month. The issue is whether §365(d)(3) requires prorating



Joel H. Levitin

the "stub rent" for the first month of the bankruptcy case between the pre- and postpetition periods, or whether the debtor must pay the entire first month's rent as a "stub rent" postpetition administrative expense. "Stub rent" is the rent due for the interim period between the petition date in the bankruptcy case and the end of the debtor's first month in bankruptcy.

Some courts have held that the date a rental payment is due determines whether it constitutes a prepetition or a postpetition obligation. Others have held that a debtor is obligated to make *pro rata* rental payments for any postpetition period in

<sup>1</sup> The views expressed herein do not necessarily reflect those of Cahill Gordon & Reindel LLP or its clients.

<sup>2</sup> In re Stone Barn Manhattan LLC, 2008 Bankr. LEXIS 3260, 2008 WL 5265739 (Dec. 17, 2008).

### About the Authors

Joel Levitin is a partner and Richard Stieglitz Jr. is an associate in the Business Restructuring and Reorganization Group at Cahill Gordon & Reindel LLP in New York.

which it utilizes a leased space, regardless of when the monthly payment was due. In *Stone Barn*, the court reviewed the various precedents and associated arguments and determined that proration was the appropriate result.

### Section 365(d)(3)

Section 365(d)(3) provides in pertinent part that "the trustee shall timely perform all obligations of the debtor...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)." 11 U.S.C.A. §365(d)(3).

## Feature

Congress enacted §365(d)(3) in 1984 to ameliorate the perceived inequity that landlords were often forced to make their property available to a debtor during the postpetition, pre-rejection period for the lease without receiving adequate compensation in return under §503(b)(1). Section 503(b)(1) is the administrative expense provision which is construed narrowly and places a significant burden on a party to prove that the use of its property is an actual and necessary cost of preserving the debtor's estate.

Congress leveled the playing field with §365(d)(3). Before the enactment of §365(d)(3) in 1984, certain courts had occasionally adjusted rental amounts during a case by applying a market rate for use and occupancy (which could be lower

than the lease rate).<sup>3</sup> Section 365(d)(3) eliminated the exercise of this discretion, by requiring the timely payment of rent at the rate expressly provided in the lease. Although courts generally agree on what §365(d)(3) was designed to accomplish, they have not agreed on its application due to some ambiguities in the statutory language, giving rise to significant conflict among and within the circuits regarding the payment of stub rent and related obligations to landlords.



Richard A. Stieglitz Jr.

### Existing Precedent: Split of Authority

In *In re Montgomery Ward Holding Corp.*, 268 F.3d 212 (3d Cir. 2001), the Third

Circuit Court of Appeals held that the date when obligations become due determines whether they are pre- or

postpetition obligations and that the proration approach was not appropriate. Specifically, a split panel found that tax obligations owed under a lease that became due—in contrast to when they were incurred—were required to be paid in full as postpetition obligations, even though at least a portion of the obligations was incurred during a prepetition period. The courts in *Koenig Sporting Goods Inc. v. Morse Road Co.* (*In re Koenig Sporting Goods Inc.*), 203 F.3d 989-90 (6th Cir. 2000), and *Ha-Lo Industries v. Centerpoint Properties Trust*, 342 F.3d 800 (7th Cir. 2003), found that a debtor could not prorate rent owed to a lessor when rejection

<sup>3</sup> In November 2008, BH S&B filed for chapter 11 bankruptcy protection and is currently engaged in going-out-of-business sales for all remaining Steve & Barry's stores.

occurred after the first day of the month and required the debtor to pay rent for the whole month.

On the other hand, in *In re Handy Andy Home Improvement Centers Inc.*, 144 F.3d 1128-29 (7th Cir. 1998), the Seventh Circuit Court of Appeals concluded that §365(d)(3) requires the proration of obligations (in this case, tax payments) when a case is filed in the middle of a month. As described above, the appeals court later diverged from this approach in the rejection context in *Ha-Lo Industries*, and rent is due at the beginning of the month.<sup>4</sup>

To add to the confusion, district and bankruptcy court judges are similarly split on the issue, sometimes within the same district. Compare *In re Comdisco Inc.*, 272 B.R. 671 (Bankr. N.D. Ill. 2002); and *In re F&M Distributors Inc.*, 197 B.R. 829 (Bankr. E.D. Mich. 1995) (disfavoring proration), with *In re Furr's Supermarkets Inc.*, 283 B.R. 60 (10th Cir. B.A.P 2002); *In re Child World*, 161 B.R. 571 (S.D.N.Y. 1993); *In re Ames Dept. Store Inc.*, 306 B.R. 43 (Bankr. S.D.N.Y. 2004); and *In re NETtel Corp. Inc.*, 289 B.R. 486 (Bankr. D. Col. 2002) (all favoring proration).

## Stone Barn Manhattan LLC: The Case for Proration

The court determined that the debtors were responsible for stub rent measured on a daily basis from the petition date until the end of July. The court found that because §365(d)(3) requires the timely payment of obligations under all leases during the period while a debtor is deciding whether to assume or reject, the goals of the Bankruptcy Code are best carried out through proration. The court concluded that proration successfully balances the purposes of the Bankruptcy Code (especially §365(d)(3)) with the necessary protections to which creditors are entitled after the petition date. The court rejected the view of certain courts that the natural reading of the statute and the intent of Congress preclude proration and instead decided that the language of §365(d)(3) actually favors proration.<sup>5</sup>

Specifically, the court found that the proration approach, which it

observed was relatively simple to apply, equitable to all parties and consistent with prior practice, only measures the magnitude of obligations that are due as postpetition claims and does not eliminate or modify any rights or obligations of parties without the necessary power to do so coming from the Bankruptcy Code, which had been one of the concerns of the courts that had previously rejected this approach.<sup>6</sup> The court also reasoned that if a debtor was going to receive the benefit of using the underlying property during the stub period, then it should also be obligated to pay for such benefits on the terms dictated by the lease (rather than by potentially providing the landlord with an administrative claim and deferring payment until a later date, if at all). Finally, the court noted that if proration was not the rule, debtors would be incentivized to file cases on the second day<sup>7</sup> of a month, harming lessors, unfairly benefiting debtors and other creditors, and potentially leading to absurd results and practices.<sup>8</sup>

## Conclusion

Understanding the importance of this issue, the court *sua sponte* stayed its decision and agreed to include a certificate supporting an immediate appeal to the U.S. Court of Appeals for the Second Circuit.

To the extent the appeals court (and potentially the Supreme Court) considers this issue, the approach and logic of the *Stone Barn* decision is compelling. Not only is it consistent with the general principle that a debtor must timely pay its postpetition obligations, it is easy and practical to apply, and it is also fair and equitable to debtors and landlords. The proration approach gives debtors the benefit of bankruptcy for any prefiling stub period, while at the same time protecting and compensating landlords for the postfiling stub period. Compared with the two other potential approaches (*i.e.*, payment of no rent during the filing month or payment of rent during the filing month even if the due date is before the petition date), the proration method is clearly the most appropriate. ■

*Reprinted with permission from the ABI Journal, Vol. XXVIII, No. 1, February 2009.*

*The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization*

<sup>4</sup> In *Ha-Lo Industries*, the court found *Handy Andy* to be inapplicable, because the obligation at issue in *Handy Andy* was real estate taxes that accrued prepetition, while the obligation due in *Ha-Lo Industries* was postrejection rent for a lease rejected mid-month. The court emphasized that the difference turned on the fact that rent for the full month became due before rejection and therefore was an expense of administration that must be paid.

<sup>5</sup> *Id.* at pps. 6-7.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

*devoted to bankruptcy issues. ABI has nearly 11,700 members, representing all facets of the insolvency field. For more information, visit ABI World at [www.abiworld.org](http://www.abiworld.org).*