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# THE PAYMENT OF “STUB RENT” UNDER THE BANKRUPTCY CODE

*Michael J. Lichtenstein\**

When a tenant under a non-residential real property lease files a petition under the Bankruptcy Code, obviously the landlord would like to receive all of its post-petition rent as an administrative expense.<sup>1</sup> On the other hand, to the extent possible, the debtor/tenant would rather that the landlord's claim be classified as a pre-petition unsecured claim. The question discussed in this article is whether rent that is due for the month of the filing is pre-petition rent or post-petition rent. While the Bankruptcy Code provides no clear answer to this dilemma, there are two schools of thought represented in the various bankruptcy court and appellate decisions on this issue.

The first approach views the billing date on the lease as the operative date to determine whether rent is a pre-petition or post-petition expense. Adoption of this approach favors the debtor/tenant which might choose to file a bankruptcy petition several days after the first of the month to avoid having to pay administrative rent for one entire month. The second approach treats rent on an accrual basis so that a claim can be pro-rated based on the bankruptcy filing date. In a jurisdiction that has adopted the second approach, a debtor/tenant will be liable for a pro-rated share of administrative rent, determined from the date of filing through the end of the month. Courts that have adopted this approach usually rule that payment of administrative rent must be made currently rather than be allowed to accrue until the end of the case.

## **A. Section 365(d)(3)**

Section 365 of the Bankruptcy Code deals with unexpired leases and executory contracts. There are specific sub-provisions focusing

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on the rights of commercial landlords. Section 365(d)(3) provides in relevant part:

The trustee shall timely perform all of the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease . . . , until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.<sup>2</sup>

Numerous courts have held that 11 U.S.C. § 363(d)(3) is ambiguous in many respects, and have thus interpreted it differently when it comes to the payment of "stub" rent. The ambiguity,<sup>3</sup> they contend, arises from the meaning of when a debtor's obligation "arises" and whether such "obligation" is one that arises "from and after the order for relief."<sup>4</sup>

## **B. Billing Date Approach**

Under the billing date approach, § 365(d)(3) only applies to obligations for which the payment date arises after the petition date pursuant to the terms of the lease. This approach has been adopted by three Circuit Courts of Appeal<sup>5</sup> which have issued opinions. Under this approach, an obligation arises on the date "when one becomes legally obligated to perform." *Montgomery Ward*.<sup>6</sup> This literal approach distinguishes between having the obligation arise under the terms of the lease and having a mere claim, which claim may have its origin in a breached obligation of the debtor which was required to be paid prior to the order for relief.<sup>7</sup>

*In re Montgomery Ward Holding Corp.*,<sup>8</sup> involved the debtor's obligation to reimburse the landlord for real estate taxes. Although the landlord's liability accrued in large part prior to the petition date, the debtor's reimbursement obligation arose post-petition.<sup>9</sup> While the landlord argued that the invoices were payable as obligations arising from the lease, the debtor asserted that it should only pay real estate taxes attributable to the post-petition period.<sup>10</sup> The Bankruptcy Court ruled for the debtor and the district court affirmed.<sup>11</sup>

The Third Circuit reversed, holding that the tax obligation arose post-petition and had to be paid in full.<sup>12</sup> According to the Third Circuit: "The clear and express interest of § 365(d)(3) is to require the trustee to perform the lease in accordance with its terms."<sup>13</sup> Under this analysis, it is difficult to justify a proration approach.<sup>14</sup> The Third Circuit acknowledged its reluctance in rejecting the proration approach, considering various other Courts' opposite conclu-

sion, but noted that: “It is not our role, however, to make arguably better laws than those fashioned by Congress.”<sup>15</sup>

In *In re Ha-Lo Industries, Inc.*,<sup>16</sup> the debtor appealed the lower court’s order that the debtor pay its former landlord the remainder of a full month’s rent due under an office lease which covered a post-rejection period too. Under the terms of the lease, rent was due on the first day of each month.<sup>17</sup> After filing a bankruptcy petition in July, the debtor sought to reject the lease effective November 2.<sup>18</sup> On November 1st, the debtor made a partial lease payment representing the three days in November that the premises would be occupied.<sup>19</sup> The landlord accepted the rent but demanded payment for the balance of November.<sup>20</sup> Upon the debtor’s refusal, the landlord sought and obtained an order compelling immediate payment of administrative rent for the balance of November.<sup>21</sup> The district court affirmed.<sup>22</sup>

The Seventh Circuit agreed that rent was due for the entire month because the debtor was obligated to pay for the month on the first day of the month.<sup>23</sup> The Seventh Circuit distinguished a prior pro-ration decision (*Handy Andy*)<sup>24</sup> because that case involved non-rent (*i.e.*, real estate taxes).<sup>25</sup> However, the Seventh Court viewed rent as “a charge for the consumption of a resource during the administration of the lease” as opposed to pre-paid real estate taxes which is a risk cost relating to the pre-petition period.<sup>26</sup>

The Seventh Circuit pointed out that the debtor controlled the timing and could have rejected the lease effective October 31, rather than November 2.<sup>27</sup> Accordingly, “we agree with the Sixth Circuit that equity as well as the statute favors full payment.”<sup>28</sup>

The Sixth Circuit considered “stub rent” in *In re Koenig Sporting Goods, Inc.*,<sup>29</sup> where the debtor appealed from a judgment awarding the landlord a full month’s rent. The lease required the debtor to pay rent on the first day of the month.<sup>30</sup> The debtor sought to reject the lease effective the second day of the month and the landlord moved for payment of a full month’s rent.<sup>31</sup> The Sixth Circuit noted that under the lease, payment was due in advance for the entire month.<sup>32</sup> Because the debtor controlled the rejection date, the Sixth Circuit concluded that both equity and the Bankruptcy Code favored the landlord.<sup>33</sup>

### C. Accrual Approach

Under the second approach, known as the accrual method, obligations under § 365(d)(3) are prorated, based on pre-petition and post-

petition accruals. Several courts followed this approach based on adherence to the case law under the old Bankruptcy Act and an alleged concept of fairness.<sup>34</sup>

Under this view, a debtor is required by Section 365(d)(3) to timely pay those amounts due under a lease that pertain to the benefits realized by the estate during the post-petition, pre-rejection period regardless of when the payment(s) became due. In other words, the obligations arising under a lease are prorated based upon whether and to the extent that they relate to benefits that were enjoyed by the debtor on a pre-petition basis or a post-petition, pre-rejection basis.<sup>35</sup>

For example, in *In re Furr's Supermarkets*,<sup>36</sup> the bankruptcy court ordered the debtor only to pay the pro-rated portion of rent. The Tenth Circuit Bankruptcy Appellate Panel affirmed, believing the pro-ration rate to be the better interpretation of Section 365(d)(3).<sup>37</sup> The Tenth Circuit BAP concluded that pro-ration is more consistent with the legislative purpose underlying Section 365(d)(3).<sup>38</sup> The Court expressed a concern that adopting the billing rate approach would eliminate the priority of pre-petition claims.<sup>39</sup> Reading Section 365(d)(3) in context led to the conclusion that Section 365 protects landlords from the status of involuntary creditors and entitles them to payment for rent that accrues post-petition.<sup>40</sup>

In Maryland, Judge Derby adopted the accrual method in connection with a debtor's obligation to reimburse its landlord for certain real property taxes as required under the parties' lease of nonresidential real property.<sup>41</sup> In *Dunn*, the debtor filed a petition for chapter 11 bankruptcy protection on June 2, 2004. The debtor/lessee had an obligation under its lease agreement to reimburse its landlord for certain Maryland real property taxes paid by the landlord on the debtor's behalf, which taxes were payable by the landlord yearly in advance. On or about July 21, 2004, the landlord provided the debtor with an invoice for the real property taxes for the period July 1, 2004 through June 30, 2005, which the landlord had recently paid on the debtor's behalf. The debtor maintained that its real property tax reimbursement obligation accrues and, therefore, arises under Section 365(d)(3) only for each day that the debtor occupies the leasehold premises on a post-petition, pre-rejection basis. Accordingly, the debtor argued that it should only be liable for the real property tax payments on a monthly, pro-rated basis post-petition until the lease is assumed, assumed and assigned, or rejected.<sup>42</sup>

In addressing the issue, Judge Derby concluded that Section 365(d)(3) is ambiguous and that the “better reasoned and more equitable approach” is the application of the majority’s accrual approach for the classification and treatment of the debtor’s real property tax reimbursement obligation under its lease.<sup>43</sup> Central to the court’s conclusion to apply the accrual approach was the concern that the application of the billing date approach to Section 365(d)(3) would result in an impermissible, judicially-created exemption to the definition and treatment of “claims” pursuant to various provisions of the Bankruptcy Code.<sup>44</sup> Judge Derby reasoned as follows:

Although Section 365(d)(3) explicitly makes lease obligations arising post-petition payable without regard to whether they satisfy the specific tests for administrative expenses under Section 603(b)(1), *e.g.*, whether they are actual, necessary costs of preserving the estate, the section does not make an exception for the provisions of the Bankruptcy Code that deal with claims. If the term obligations is read to arise when billed, it may include obligations to pay taxes which cover prepetition periods. Such a reading conflicts with the treatment of prepetition claims by converting real property tax claims for prepetition periods to post-petition, first priority obligations. On the other hand, if the term obligations is read to arise when accrued, property tax obligations for pre- and post-petition periods are matched with each other. The latter resolution of the ambiguous term is thus more faithful to the general principles of the Bankruptcy Code for adjusting creditors’ rights equitably.<sup>45</sup>

In addition, the *Dunn* court expressed concern that following the billing date approach would all allow the landlord to manipulate the billing date for taxes, or the debtor to manipulate the timing of its bankruptcy filing, so as to improve the party’s treatment under the Bankruptcy Code:

The billing method would prompt Maryland lessors to time their presentation of tax bills to tenants they anticipate might file bankruptcy in the hope of making the entire bill a post-petition priority expense, while prospective debtors would time their bankruptcy filings based on the receipt of tax bills in order to render an entire years’ tax obligation an unsecured pre-petition debt. Both behaviors are solely to obtain advantage and do nothing to preserve the relative positions of the parties on a level playing field while reorganizing. Neither contributes to the integrity of the system, and neither behavior should be promoted.<sup>46</sup>

In *Travel 2000*, the debtor filed a voluntary petition under Chapter 11 of the Bankruptcy Code on February 2, 2001 and took the posi-

tion that since rent for February of 2001 was "due" pre-petition, 11 U.S.C. § 365(d)(3) did not compel payment of rent for the post-petition period of February 2-28, 2001.<sup>47</sup> The court analyzed both approaches and adopted the proration approach.<sup>48</sup> In so holding, the court cited to the remarks of Senator Orrin Hatch in the legislative history of 11 U.S.C. § 365(d)(3):

[T]he landlord is forced to provide current services - the use of his property, utilities, security, and other services without current payments. No other creditor is put in this position . . . The bill would lessen these problems by requiring the trustee to perform all the obligations of the debtor under a lease of nonresidential real property at the time required in the lease. This timely performance requirement will insure that debtor-tenants pay their rent, common area charges, and other charges on time pending the trustee's assumption or rejection of the lease.<sup>49</sup>

In *Travel 2000*, the court concluded, therefore, that although the "responsibility to pay rent crystallized on the first of the month . . . the Debtor's obligation arose each day in the month of February."<sup>50</sup> The court therefore held that the landlord was entitled to be paid on a *pro rata* basis under 11 U.S.C. § 365(d)(3).<sup>51</sup>

The proration approach is also consistent with the view of the courts which have addressed "other rent" items, such as real property taxes and common area maintenance fees.<sup>52</sup>

#### **D. Immediate Payment of Administrative Rent**

As noted, several courts have required immediate payment of post-petition rent. In *In re MHI, Inc.*,<sup>53</sup> a commercial landlord sought payment of a post-petition rent under Section 365(d)(3) of the Bankruptcy Code. Even though the debtor had never occupied the space, the landlord contested it was entitled to administrative rent until the lease was rejected.<sup>54</sup> The Bankruptcy Court concluded that under the then recent changes to the Bankruptcy Code, the landlord was entitled to the relief it sought.<sup>55</sup> The Bankruptcy Court concluded that Section 365(d)(3) (requiring timely performance) was added specifically to protect lessor of non-residential real property.<sup>56</sup>

Similarly, in *In re Dieckhaus Stationers of King of Prussia, Inc.*,<sup>57</sup> the landlord sought immediate payment of all rent due until the surrender of the premises. The court found that the claim entitled the landlord to immediate payment of administrative rent.<sup>58</sup> Reviewing the legislative history of 1984 "shopping center" amendments to

the Bankruptcy Code led the court to conclude that Congress sought to ease the burden on commercial landlords.<sup>59</sup> Further, Congress clearly envisioned that tenants would pay their rent on time.<sup>60</sup> Accordingly, administrative rent claims should be paid immediately unless good cause is shown for withholding payment.<sup>61</sup>

## E. Conclusion

There still exists a split in the circuits regarding the payment of “stub rent.” Some courts look at the billing date while others have held that a non-residential landlord is entitled to all rents that accrue post-petition. Generally, courts do not want to saddle an estate with administrative expenses and provide a windfall to a commercial landlord. On the other hand, some courts have noted that a debtor chooses when to file a bankruptcy petition and has the ability to avoid incurring a rent obligation by filing prior to the date the next rent payment is due. To the extent administrative rent is payable, several courts have required that immediate payment be made to the landlord.

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<sup>1</sup>Administrative expenses must be paid in full as opposed to unsecured claims which may receive little or nothing in a Chapter 11 proceeding. The rent for the pre-petition period in the month the bankruptcy petition is filed is known as “stub” rent.

<sup>2</sup>11 U.S.C. § 365(d)(3).

<sup>3</sup>“Ambiguity emanates from the words ‘arises’ and ‘obligation.’ An ‘obligation’ can ‘arise’ when it comes due and payable or when it accrues.” *Id.* at 450, citing *In the Matter of Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998). *But see In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 211 (3rd Cir. 2001) (holding that Section 365(d)(3) is unambiguous).

<sup>4</sup>*In re Travel 2000, Inc.*, 264 B.R. 444, 447 (Bankr. W.D. Mich. 2001).

<sup>5</sup>In an unpublished decision, the citation of which is disfavored, the Fourth Circuit used the billing date method in connection with the payment of real property rent. *In re Rose’s Stores, Inc.*, 155 F.3d 560 (4th Cir. 1998).

<sup>6</sup>268 F.3d at 209.

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

<sup>8</sup>268 F.3d at 212.

<sup>9</sup>*Id.* at 207.

<sup>10</sup>*Id.* at 208.

<sup>11</sup>*Id.*

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<sup>12</sup>*Id.* at 212.

<sup>13</sup>*Id.* at 209.

<sup>14</sup>*Id.*.

<sup>15</sup>*Id.* at 211.

<sup>16</sup>342 F.3d 795, 796 (7th Cir. 2003).

<sup>17</sup>*Id.*

<sup>18</sup>*Id.*

<sup>19</sup>*Id.* at 797.

<sup>20</sup>*Id.*

<sup>21</sup>*Id.*

<sup>22</sup>*Id.*

<sup>23</sup>*Id.* at 798.

<sup>24</sup>In an earlier decision in *In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998), the Seventh Circuit seemed to adopt the proration theory of § 365(d)(3). The dispute was over the payment of real estate taxes which had accrued pre-petition but became payable when billed post-petition. However, in *Ha-Lo*, the court expressly limited *Handy Andy* to the payment of taxes that had accrued during pre-petition occupancy, held to be akin to "sunk costs" not chargeable to the postpetition debtor, even though billed postpetition." *Ha-Lo*, 342 F.3d at 798–99. With respect to rent, the Seventh Circuit expressly adopted the plain meaning approach taken by *Montgomery Ward and Koenig Sporting Goods*. Clearly, the Seventh Circuit was struggling to apply the plain meaning rule without expressly overruling *Handy Andy*.

<sup>25</sup>*Id.*

<sup>26</sup>*Id.* at 799.

<sup>27</sup>*Id.* at 800.

<sup>28</sup>*Id.*

<sup>29</sup>203 F.3d 986, 989 (203 6th Cir. 2000).

<sup>30</sup>*Id.* at 987.

<sup>31</sup>*Id.* at 988.

<sup>32</sup>*Id.* at 989.

<sup>33</sup>See also *In re Baby N'Kids Bedroom, Inc.*, 2007 WL 1218768 \*4 (D. Mich. April 27, 2007) (applying *Koenig* logic and result to landlord's claim for administrative rent under Section 503(b)).

<sup>34</sup>See, e.g., *In re Child World, Inc.*, 161 B.R. 571, 575 (S.D.N.Y. 1993) (legislative history explains that Congress sought to ensure that landlords received current payment for current services). See also, *In re Furr's Supermarkets, Inc.*, 283 B.R. 60, 69–70 (10th Cir. B.A.P. 2002) (rent, taxes and other lease obligations arise under Section 365(d)(3) as they accrue).

<sup>35</sup>See *In re Furr's Supermarkets, Inc.*, 283 B.R. at 69–70; *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d. at 1127; *In re Child World, Inc.*, 161 B.R. at 576–77; *In re Dunn Indus., LLC*, 320 B.R. 86, 90–93 (Bankr. Md. 2005); *In re Travel 2000, Inc.*, 264 B.R. at 450–51.

<sup>36</sup>*In re Furr's Supermarkets, Inc.*, 283 B.R. at 62. See also *In re NetTel Corp.*, 289 B.R. 486, 492 (Bankr. D.D.C. 2002) (criticizing the billing date approach for converting pre-petition debt into administrative claims).

<sup>37</sup>*Id.*

<sup>38</sup>*Id.* at 68.

<sup>39</sup>*Id.*

<sup>40</sup>*Id.* at 69.

<sup>41</sup>See *In re Dunn Indus., LLC*, 32 B.R. 86 (Bankr. Md. 2005).

<sup>42</sup>*Id.* at 87–88.

<sup>43</sup>*Id.* at 88–93.

<sup>44</sup>*Id.* at 90.

<sup>45</sup>*Id.*

<sup>46</sup>*Id.* at 93.

<sup>47</sup>264 B.R. at 445–46.

<sup>48</sup>*Id.* at 450.

<sup>49</sup>*Id.* at 448, quoting 130 Cong.Rec. S8887, S8994–95 (daily ed. June 29, 1984).

<sup>50</sup>*Id.* at 451.

<sup>51</sup>*Id.* at 450. See also *In re Automationsolutions, Int'l, LLC*, 2002 WL 31863871 (Bankr. N.D. Cal. Aug. 16, 2002) (following *Travel 2000*); and *NETtel*, 289 B.R. at 490–91 (analyzing each approach and adopting the proration/accrual approach stating that “landlord’s entitlement to compensation for occupancy at a fixed periodic rate relates to the actual days the tenant was entitled to occupancy, and in a practical and fundamental economic sense can be said to arise on each occupancy day” and holding that “[v]iewing the term ‘arises under’ in its accrual sense is most consonant with the spirit of § 365(d)(3) itself as well as the Bankruptcy Code as a whole.”)

<sup>52</sup>See, e.g., *In re Trak Auto Corp.*, 277 B.R. 655, 662–64 (Bankr. E.D. Va. 2002), reversed on other grounds, 367 F.3d 237 (4th Cir. 2004) (“Anything accruing after the entry for the order for relief is a post-petition charge that may be elevated to administrative priority.”); *In re Best Prods. Co.*, 206 B.R. 404, 407 (Bankr. E.D. Va. 1997) (payment of real estate taxes must be prorated).

<sup>53</sup>61 B.R. 69 (Bankr. Md. 1986).

<sup>54</sup>*Id.* at 70.

<sup>55</sup>*Id.* at 71.

<sup>56</sup>*Id.*

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<sup>57</sup>73 B.R. 969, 970 (Bankr. E.P. Pa. 1987).

<sup>58</sup>*Id.*

<sup>59</sup>*Id.* at 972.

<sup>60</sup>*Id.*

<sup>61</sup>*Id.* See also *In re Musikhon Corp.*, 57 B.R. 942, 944 (Bankr. E.D.N.Y. 1986) (clear language of Section 365(d)(3) specifies that trustee must divide by post-petition rent obligations.)