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## Stub Rent: The Third Circuit's Decision in *Goody's*

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Over the last year, the *Journal* has featured two articles pertaining to stub rent and the conflicting approaches courts have adopted with respect to payment of stub rent.<sup>1</sup> Recently, the Third Circuit Court of Appeals issued a decision in *In re Goody's Family Clothing Inc.*,<sup>2</sup> which held that § 365(d)(3) does not supplant § 503(b) and landlords are entitled to stub rent as an administrative expense, clarifying the circuit's approach to stub rent. This article addresses stub rent and examines the Third Circuit's decision in *Goody's*.

### An Overview of § 365(d)(3) and the Stub Rent Conflict



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or rejected, notwithstanding section 503(b)(1).<sup>3</sup> The purpose of § 365(d)(3) is to protect landlords by requiring debtors to timely perform their obligations arising under a lease pending the assumption or rejection of the lease.<sup>4</sup>

Section 365(d)(3) requires a debtor 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

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Section 365(d)(3), however, has not been consistently applied by courts—even courts within the same district.

More specifically, courts are divided on whether § 365(d)(3) requires the timely payment of stub rent, the amount due to a landlord for the period of occupancy and use between the entry of an order for bankruptcy relief (generally, the petition date) and the first

enforceable duty to perform arises under that lease."<sup>8</sup>



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Other courts have adopted the "proration" approach, finding that the obligation to pay the monthly rent is allocated on a *pro rata* basis for those days the debtor actually occupied the premise. Utilizing the

proration approach, a landlord has a § 365(d)(3) claim for the immediate payment of rent for the stub period.

For example, in *Stone Barn Manhattan*, the Southern District

## Practice & Procedure

post-petition payment, and the interplay between §§ 365(d)(3) and 503(b)(1)<sup>5</sup> of the Bankruptcy Code. Some courts have adopted the "billing-date" approach, finding that the obligation to pay rent arises on the date the rent is due.<sup>6</sup> Consequently, if rent is due on the first of the month and the tenant files for bankruptcy later in the month, under the billing-date approach, none of the rent is considered a post-petition obligation subject to payment under § 365(d)(3).

In *Montgomery Ward Holding Corp.*, the Third Circuit concluded that the plain language of § 365(d)(3) mandates a billing date approach be used to determine when a lease obligation arises.<sup>7</sup> The court concluded that an "obligation arises under a lease for the purposes of 11 U.S.C. § 365(d)(3) when the legally

of New York adopted a "proration" approach, finding that the debtors were responsible for stub rent in the month of the filing in the amounts set forth in the leases as required under § 365(d)(3).<sup>9</sup> The court reasoned that the proration approach does not disturb the purpose of § 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."<sup>10</sup> The court noted that Congress intended for § 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 § 503(b).<sup>11</sup> Under the billing-date approach, the landlords would have to provide "proof of 'benefit to the estate' during the stub period in exchange for a further (instead of

<sup>1</sup> See the July/August 2009 *Journal* for a feature entitled "Stub Rent and the Way Around *Montgomery Ward*," by Robert L. LeHane, Gilbert R. Saydah, Jr. and Heather Elizabeth Allen. See also the May 2010 issue for a feature entitled "Sportsman's Warehouse and the Latest from Delaware on Stub Rent," by David A. Beck.

<sup>2</sup> *In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010).

<sup>3</sup> 11 U.S.C. § 365(d)(3).

<sup>4</sup> See, e.g., *In re Valley Media Inc.*, 290 B.R. 73 (Bankr. D. Del. 2003).

<sup>5</sup> Section 503(b) provides that "[a]fter notice and a hearing, there shall be allowed administrative expense, other than claims allowed under section 502(f) of this title, including—(1)(A) the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A).

<sup>6</sup> See, e.g., *In re F & M Distributors Inc.*, 197 B.R. 829, 831 (Bankr. E.D. Mich. 1995); *In re Krystal Co.*, 194 B.R. 161, 163-164 (Bankr. E.D. Tenn. 1996).

<sup>7</sup> See *In re Montgomery Ward Holding Corp.*, 268 F.3d 204 (3d Cir. 2001).

<sup>8</sup> *Id.* at 211.

<sup>9</sup> *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008).

<sup>10</sup> *Id.* at 365-66.

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

current) claim for payment, after the time consuming and costly process of notice and a hearing.”<sup>12</sup> Therefore, the court reasoned that the billing-date approach contradicts the purpose of § 365(d)(3), which is to provide landlords timely compensation for post-petition use of property.<sup>13</sup>

## The Goody's Case

The recently-released opinion in *In re Goody's Family Clothing Inc.* clarifies the treatment of stub rent in the Third Circuit. Goody's Family Clothing and certain of its subsidiaries (collectively, “Goody's” or the “debtors”) filed voluntary petitions under chapter 11 on June 9, 2008.<sup>14</sup> Prior to the bankruptcy filing, Goody's and certain landlords entered into leases for nonresidential real property in various shopping venues around the country.<sup>15</sup> The leases provided that rent would be paid in advance on the first day of each month during the term of the lease. Goody's did not pay June rent but resumed the payment of rent in July.<sup>16</sup> Goody's continued to occupy the properties owned by the landlords, and sales occurred on the premises.<sup>17</sup> A liquidator sold the merchandise in the designated stores, taking a portion for itself and turning over the balance of the proceeds to the estate.<sup>18</sup>

The landlords filed administrative-expense claims seeking immediate payment of June stub rent—the rent for the 21-day period from the petition date through June 30, 2008—characterizing it as unpaid, post-petition rent that was an actual, necessary cost and expense of preserving the estate.<sup>19</sup> Goody's objected, arguing that the stub rent was due under the leases prior to the petition date, and therefore, was a general, unsecured pre-petition claim entitled to no special priority.<sup>20</sup> Goody's also argued that § 365 was the exclusive source of obligations and remedies under unexpired leases, making any reference to § 503(b)(1) contrary to statute and controlling precedent.<sup>21</sup>

The bankruptcy court heard argument on the landlords' motions for administrative-expense claims and granted them, but refused to require immediate payment.<sup>22</sup> An appeal was taken to the dis-

trict court, which affirmed.<sup>23</sup> The debtors then appealed to the Third Circuit.

On appeal, the Third Circuit considered two issues: (1) whether § 365(d)(3) precludes the attempted use of § 503(b)(1) to recover stub rent and (2) if not, whether stub rent may be considered an administrative expense under § 503(b)(1).<sup>24</sup> The court held that § 365(d)(3) does not supplant § 503(b) and the landlords were entitled to stub rent as an administrative expense.

## The Third Circuit's Analysis

With respect to the first issue, Goody's argued, in part, that under the *Montgomery Ward* decision, it was not required to pay for the occupancy from June 9 to June 30 because § 365(d)(3) does not mandate it.<sup>25</sup> Examining the court's prior ruling in *Montgomery Ward*, the court agreed that Goody's was not required under § 365(d)(3) to pay the June 1, 2008, pre-petition obligation. The court, however, observed that *Montgomery Ward* considered only a debtor's obligations under § 365(d)(3) and did not address a debtor's obligations under § 503(b)(1) for the actual occupancy of the leased premises.<sup>26</sup>

Based on the statute's plain language, the Third Circuit concluded that § 365(d)(3) does not foreclose a landlord from relying on § 503(b)(1) to recover stub rent; rather, § 365(d)(3) offers a less burdensome mechanism for a landlord to recover rent payments due and owing after a debtor files for bankruptcy.<sup>27</sup> In addition, the court noted that the landlords did not give up any rights under the Bankruptcy Code by accepting the July 1, 2008, payment from Goody's.<sup>28</sup> The court concluded that “[w]hen a debtor occupies post-petition non-residential space it leases, that § 365(d)(3) provides when the rent obligation arises does not erase when lessors may make 503(b)(1) claims for the value conferred post-petition by the occupancy.”<sup>29</sup>

The court also noted that although “mere occupancy is not always an actual and necessary expense that benefits an estate, there can be no reasonable dispute that the occupation of the leased premises...conferred a benefit.”<sup>30</sup> The court

observed that Goody's obtained more than 105 percent recovery from the store-closing sales and found that the sales were an integral part of the bankruptcy proceeding. Accordingly, the court held that the landlords were entitled to receive payment under § 503(b)(1) for use of their nonresidential real property during the stub period and that § 365(d) does not preempt § 503 in this regard.<sup>31</sup>

## Conclusion

For now,<sup>32</sup> a landlord seeking the payment of stub rent must consider the jurisdiction in which the bankruptcy case is pending. The Third Circuit's decision in *Goody's* provides clarity with respect to the treatment of stub rent in the Third Circuit. In that circuit, a landlord must affirmatively seek payment of the stub rent as an administrative-expense claim under § 503(b)(1). To the extent the claim is challenged, the landlord must be prepared to meet its burden and establish that the rent obligation is an actual and necessary expense that benefits the estate. An administrative-expense claim under § 503(b)(1), however, need not be “timely paid.”<sup>33</sup> Therefore, despite the award of an administrative claim for stub rent, a landlord may not be paid until the lease is assumed or a plan is confirmed. ■

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<sup>12</sup> *Id.* at 367.

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

<sup>14</sup> *Goody's*, 610 F.3d at 815.

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

<sup>16</sup> *Id.*

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

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

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

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

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

<sup>22</sup> See *In re Goody's Family Clothing Inc.*, 392 B.R. 604 (Bankr. D. Del. 2008).

<sup>23</sup> See *In re Goody's Family Clothing Inc.*, 401 B.R. 656 (D. Del. 2009).

<sup>24</sup> *Goody's*, 610 F.3d at 816.

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

<sup>26</sup> *Id.* at 817.

<sup>27</sup> *Id.* at 818.

<sup>28</sup> The court noted that the last sentence of § 365(d)(3) provides that “[a]cceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.” *Goody's*, 610 F.3d at 817. The court remarked that “it would put lessors in an awkward place if, while debtors were required to pay them on time pursuant to § 365(d)(3), accepting such a payment served also to deprive lessors of the balance of their rights under the Code.” *Id.*

<sup>29</sup> *Id.* at 818.

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

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

<sup>32</sup> As of the submission of this article, the time to file a petition for a writ of certiorari to the Supreme Court has not expired. In the event such a petition were granted, a Supreme Court decision could resolve the split in authority with respect to the payment of stub rent.

<sup>33</sup> See, e.g., *In re Midway Airlines Corp.*, 406 F.3d 229, 243 (4th Cir. 2005).