

BANKING & FINANCE

Getting stubbed: Collecting rent when tenant claims bankruptcy

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With the number of retail bankruptcies increasing, the treatment of rent for the period from the date of the bankruptcy filing, through the end of that month, the so-called "stub" rent, can have a large economic impact on landlords and debtors.

This article addresses steps a land-lord can take to increase its chances of receiving payment of the stub rent and minimizing the risk of non-payment.

Section 365(d)(3) of the Bankruptcy Code specifically provides that after the filing of a bankruptcy petition (post-petition), before the debtor decides whether to keep (assume) or abandon (reject) a non-residential real property lease, the debtor must timely satisfy all of its obligations under that lease.

The Bankruptcy Courts have held in published decisions that the stub rent obligation falls into one of two categories: (i) a post-petition obligation that should be timely paid in full under Section 365(d)(3); or (ii) an expense of the bankruptcy required to be satisfied upon confirmation of a plan of reorganization under Section 503(b)(1) of the Bankruptcy Code.

Recently, landlords have been unwilling to wait for payment of the stub rent until confirmation of a plan of reorganization. Their concerns are straightforward: if the rent, including real estate taxes, insurance and utilities, is due now, why should they bear the cost of advancing these expenses for the benefit of the debtor?

Also, as market conditions deteriorate, there is significant risk that the funds will not be available to pay the stub rent if the reorganization fails.

The Bankruptcy Courts throughout the country have adopted two views to determine whether stub rent is a post-petition obligation that the debtor must satisfy



timely under Section 365(d)(3) or at the end of the case under Section 503(b)(1).

One view, adopted by the Bankruptcy Courts in Delaware, as a result of the decision of the Third Circuit Court of Ap-

peals (the top appellate court for bankruptcy cases filed in Delaware), as well as the Bankruptcy Court in the Eastern District of Virginia, hold that since the rent is due prior to the bankruptcy filing (usually the first of the month), it is not a post-petition "obligation" under Section 365(d)(3).

This is known as the "when due" or "billing date" approach. Under this view, the stub rent does not have to be satisfied until the plan of reorganization is confirmed. One of the factors relied on by the courts that have adopted the when due approach, is the lack of prejudice to the landlords because the stub rent will be paid in full at the conclusion of the bankruptcy case.

In certain Bankruptcy Courts in New York, as well as in a majority of other jurisdictions, the courts have rejected the when due approach and have instead adopted the proration approach.

The proration approach holds that the stub rent should be pro-rated for each day of the month the stub rent is due and should be paid timely. The Second Circuit Court of Appeals (the top appellate court for bankruptcy cases filed in New York) has not decided the issue.

Because the Bankruptcy Courts in Delaware and Virginia do not require the immediate payment of stub rent, many large retailers (Movie Gallery, Circuit City, Linens & Things, Goody's I and II, Boscov's, Gottschalk's, KB Toys I and II, National Wholesale Liquidators), at the urging of their lenders, have (and will continue to) file bankruptcy there. The fact that all of these bankruptcies were also filed during the first half of the month is also not a coincidence: the earlier in the month the bankruptcy is filed, the greater the stub rent obligation that is deferred.

What can a landlord do? First and foremost, a landlord should retain counsel to aggressively push for the immediate payment of the stub rent.

Since market conditions are currently volatile, the landlord must be proactive: there may not be funds available to satisfy the stub rent at a later time.

The landlord cannot control the location its tenant files for bankruptcy. However, it can remove the incentive for a debtor to file bankruptcy in jurisdictions that delay the payment of stub rent, by retaining the option in the lease of moving the due date of the rent from the first to the fifteenth of the month in all future leases and request amendments in all current leases to reflect this option.

If this option is exercised, even if a debtor continues to file bankruptcy during the early part of the month, a landlord would be entitled to all the rent for the stub period immediately because the rent would not be due until the fifteenth.

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