

## Retail Bankruptcies Raise Collection Questions For Landlords

By **Kevin Newman, Nic Ferland and Scott Fleischer**

(December 2, 2019, 4:42 PM EST)

Anyone can read the Bankruptcy Code provisions that apply most often in a retailer's bankruptcy case. For landlords, however, it's not that simple when their tenant is now a debtor in possession, or DIP, and they are left wondering what they can (and can't) collect. Many of the most important concepts in retail bankruptcies — the automatic stay, stub rent, real estate taxes and cure — are colored by case law interpreting the Bankruptcy Code and play out differently depending on where a bankruptcy case is filed.

There are two approaches taken by bankruptcy courts around the country when it comes to interpreting the Bankruptcy Code's collection-related provisions for landlords: "performance date," where collection depends on when the charge came due, and "proration," where collection depends on when the charge accrued. The inconsistent approaches, which are the product of an unresolved circuit split, may have a dramatic impact on what a landlord can collect from its bankrupt tenant.

When a retailer files a bankruptcy case, landlords must immediately assess the law in the court where the case is pending. Two popular venues for such cases are Delaware (in the Third Circuit, which utilizes the performance date approach) and New York (in the Second Circuit, which utilizes the proration approach).

Especially in performance date jurisdictions, there are often disputes between landlords and debtors as to collectability. Recently, several cases in the U.S. Bankruptcy Court for the District of Delaware, such as *In re Forever 21 Inc.* and *In re Avenue Stores LLC*, have brought large-scale collection issues to light in the public eye and serve as a reminder that it is crucial for landlords to understand the legal landscape in their tenant's bankruptcy case.

When it comes to assessing the collection of lease charges, the focus is on the period following the bankruptcy petition filing date through the date the lease is assumed or rejected. Bankruptcy Code Section 365(d)(3) provides, in part, that "the [debtor] shall timely perform all the obligations of the debtor ... arising from and after the [petition date] under any unexpired lease of nonresidential real property, until such lease is assumed or rejected."<sup>[1]</sup> If a charge is considered a post-petition obligation due under



Kevin Newman



Nic Ferland



Scott Fleischer

the lease, the debtor must timely perform.

If a charge is not a post-petition obligation of the debtor that must be timely performed under the lease, landlords may also be able to look to Section 503(b)(1)(A) of the Bankruptcy Code to assert an administrative expense claim.[2]

However, what is considered a post-petition obligation due under the lease differs by jurisdictional approach and touches on many concepts.

### **Automatic Stay**

When a landlord looks to collect from its debtor-tenant, it must be keenly aware of the automatic stay, a core principle of the Bankruptcy Code. The Bankruptcy Code generally prohibits collecting a prepetition debt or seeking to obtain possession of property of the estate[3] and imposes severe penalties for violations, thereby having a huge impact on landlords when their tenants are in bankruptcy.

It is essential to know which charges are considered post-petition obligations that must be paid pursuant to the lease and Section 365 and which are considered prepetition charges that cannot be sought from the debtor. As a result, having a good handle on the approach that is utilized where the debtor's case is pending is critical to understand what can and can't be collected.

### **Stub Rent**

One of the most talked-about concepts in retail bankruptcies is stub rent, the rent and related monthly charges calculated on a pro rata basis from the date the case is filed through the end of that month.

Under the proration approach, stub rent is a post-petition obligation (an administrative priority claim under Bankruptcy Code Section 503)[4] that must be timely performed under the lease, as it accrued post-petition.[5]

Under the performance date approach, however, stub rent is not considered a post-petition obligation because the rent for that month was payable in full on the first of the month, prior to the bankruptcy filing. However, as long as the debtors have not rejected the lease as of the petition date, landlords often assert that stub rent must be paid as an administrative expense under Section 503.[6]

The dispute between the debtor and its landlords over the payment of stub rent generally comes to a head when the debtors are seeking approval of post-petition financing or use of cash collateral, where there is a proposed budget for the case that the debtors must adhere to in order to comply with the terms of the financing/cash collateral order. The sticking points often involve the lenders' proposed waiver of Sections 506(c)[7] and 552(b).[8]

In some cases, the debtor will agree to pay stub rent by a reasonable date certain that is set forth in the budget, and the lenders' waivers are contingent on the payment of stub rent. In two recent Delaware cases, though, there were disputes over the payment of stub rent.

In one of the more high-profile retail bankruptcies of the year, Forever 21[9] initially refused to pay September stub rent until it emerged from Chapter 11. As a result of landlords and the unsecured creditors committee engaging in negotiations with the debtors and many filing objections to the DIP financing motion, the debtors relented.

They agreed to pay stub rent in full by three days after the hearing, the obligation to do so was included in the order approving the DIP financing on a final basis, and stub rent has since been paid.

Another recent stub rent dispute took place in Avenue,[10] where the debtors also initially refused to pay August stub rent, and some of its landlords and the creditors committee filed objections to the proposed DIP financing. At the final DIP financing hearing, though, the debtors agreed to pay stub rent by the closing date of a sale of the debtors' e-commerce business, and if it did not pay the stub rent by that time, the lenders would not get a waiver of the debtors' right to surcharge the costs and expenses of administration of the estate under Section 506(c).

After what the debtors called a successful sale of its e-commerce business and an announcement that it would result in all case expenses being paid, stub rent was not paid by the sale closing. The United States trustee and creditors committee each recently filed motions to convert the cases from Chapter 11 to Chapter 7, and seemingly in response to those filings (and perhaps the lack of a 506(c) waiver for its lenders), the debtors filed a notice stating that stub rent had been paid in full.

Keep in mind that under either approach, the prepetition portion of the rent due for the month of the bankruptcy filing (the first of the month through the day before the petition date) is not payable under the lease per Section 365, nor would it be an administrative expense payable under Section 503. This amount must be asserted as a general unsecured claim or, if the lease is being assumed, the landlord has the right to recover it as part of the cure amount.

### **Real Estate Taxes**

As is the case for stub rent, the jurisdictional approach dictates whether real estate taxes are considered post-petition charges a landlord can recover from the debtor or prepetition charges that may only be asserted as a claim (unless the lease is assumed, in which case it would constitute part of the cure amount required to be paid).

In a proration jurisdiction, the analysis is simple — real estate taxes are considered a post-petition charge collectible by a landlord when they accrue during a post-petition, prerejection period, irrespective of when they were billed or became due. If a portion of the taxes relates to the prepetition period and another portion relates to the post-petition period, the charge would be prorated.

The key in determining whether a real estate tax charge is collectible in a performance date jurisdiction is the actual due date under the lease (not the billing date). For rent, it is almost universally the first of the month, but for taxes, this can vary significantly, making it more difficult to assess.

In many cases, a landlord pays real estate taxes to the municipality and the tenant reimburses the landlord as a part of its rental obligations under the lease. In that scenario, the due date under the lease will dictate whether the tax payment is a post-petition obligation.

In cases where the tenant is billed directly by the municipality for its share of real estate taxes, both the lease terms and tax invoice must be considered. While the lease may provide for a specific due date, for example, within a certain number of days of receipt of an invoice, the lease may instead be more vague, providing, for example, that real estate taxes are payable when due.

If the lease does not provide enough guidance, the invoice itself will govern. Often, the invoice will state

that the taxes are due by a date certain, but the tenant can pay by a later date certain after which a penalty or interest would start to accrue. In that scenario, the latter would be the true due date that governs whether it is a collectible, post-petition charge.

In a situation in which taxes are billed post-petition but the last day to pay before a penalty would accrue occurred after the rejection date, that tax charge is arguably not collectible under the performance date interpretation of Section 365.[11]

## **Cure**

The debtor's obligation to cure defaults existing under the lease at the time of assumption (or assumption and assignment) arises from Section 365(b)(1)(A).[12] All amounts that are due, but not payable under the performance date or proration approach, are included in the cure amount.

In addition to prepetition charges, the cure amount may also include attorney fees. Section 365(b)(1)(B) provides that a debtor cannot assume a lease without first compensating the landlord for "any actual pecuniary loss" resulting from a default.[13] Depending on the lease at issue, a landlord can look to this provision to assert that its counsel's fees in the bankruptcy case are also payable as part of the cure amount.

It is also important to remember that the cure concept may include more than just a dollar amount. Nonmonetary defaults such as an outstanding maintenance obligation must also be cured at the time of assumption.[14]

When a landlord is assessing a debtor's proposed cure amount, in addition to the liquidated amount, it should preserve the right to collect what may come due in the future, such as reconciliations of previously billed charges (for example, real estate taxes, common area maintenance and insurance) and to seek indemnification from the debtor as set forth in the lease. In the case of a lease assignment, this may be accomplished by the assignee affirmatively taking on those obligations or the debtor establishing an escrow account.

If a lease is rejected, however, the debtor has no responsibility to cure prepetition defaults, and the landlord must assert such amounts as a general unsecured claim.

---

*Kevin Newman and Nic Ferland are partners and Scott Fleischer is counsel at Barclay Damon LLP.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] 11 U.S.C. § 365(d)(3).

[2] 11 U.S.C. § 503(b)(1)(A) ("there shall be allowed administrative expenses ... including—the actual, necessary costs and expenses of preserving the estate").

[3] See 11 U.S.C. § 362(a).

[4] 11 U.S.C. § 503(b)(1)(A).

[5] Unless the lease is rejected as of the petition date, in which case there would be no stub rent due because nothing accrued post-petition.

[6] There are also additional bases for a landlord's argument that stub rent must be paid immediately, such as the need for adequate protection under Sections 363(e) and 361(1) and (3), and the lenders' proposed waivers of Bankruptcy Code sections 506(c) and 552(b).

[7] 11 U.S.C. § 506(c) (the debtors' right to surcharge the lender for the costs and expenses of administration of the estate, including preserving the collateral subject to the lenders' liens).

[8] 11 U.S.C. § 552(b) (the "equities of the case" exception, which permits the exclusion of post-petition proceeds from pre-petition collateral on equitable grounds).

[9] In re Forever 21, Inc., et al., case no. 19-12122 (KG) (Jointly Administered).

[10] In re Avenue Stores, LLC, et al., case no. 19-11842 (LSS) (Jointly Administered).

[11] See, e.g., In re Sportsman's Warehouse, Inc., 436 B.R. 308 (Bankr. D. Del. 2009).

[12] 11 U.S.C. § 365(b)(1)(A) ("If there has been a default in an...unexpired lease of the debtor, the [debtor] may not assume such...lease unless, at the time of assumption..., the [debtor]—cures, or provides adequate assurance that the [debtor] will promptly cure, such default").

[13] 11 U.S.C. § 365(b)(1)(B) ("If there has been a default in an...unexpired lease of the debtor, the [debtor] may not assume such...lease unless, at the time of assumption..., the [debtor]—compensates...a party other than the debtor to such...lease, for any actual pecuniary loss to such party resulting from such default").

[14] This is true with one exception: a default does not have to be cured "if it is impossible for the [debtor] to cure such default by performing nonmonetary acts at and after the time of assumption..." 11 U.S.C. § 365(b)(1)(A).