

Breaking New Ground: Delaware Bankruptcy Court Grants Administrative Priority for Postpetition, Prerejection Lease Indemnification Obligations

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Under the Bankruptcy Code, a bankruptcy trustee or chapter 11 debtor in possession (“DIP”) is required to satisfy postpetition obligations under any unexpired lease of commercial property pending a decision to assume or reject the lease. Specifically, section 365(d)(3) requires the trustee, with limited exceptions, to “timely perform all the obligations of the debtor . . . arising from and after the order for relief” under any unexpired lease of nonresidential real property with respect to which the debtor is the lessee.

The application of section 365(d)(3) and, in particular, the timing of certain “obligations” arising under an unexpired lease has created some controversy. A Delaware bankruptcy court added fuel to the fire in a ruling handed down earlier this year. In a matter of first impression, the court held in *WM Inland Adjacent LLC v. Mervyn’s LLC (In re Mervyn’s Holdings, LLC)*, 2013 BL 5408 (Bankr. D. Del. Jan. 8, 2013), that a claim arising from an indemnification obligation under a commercial lease was entitled to administrative expense status under section 365(d)(3).

Payment of Postpetition Commercial Lease Obligations

As noted, section 365(d)(3) provides that a trustee or DIP, with certain exceptions, “shall timely perform all the 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 section 503(b)(1) of this title.” Added to the Bankruptcy Code in 1984, the

provision was intended to ameliorate the immediate financial burden borne by commercial landlords pending the trustee's decision to assume or reject a lease. Prior to that time, landlords were routinely compelled to seek payment of rent and other amounts due under a lease by petitioning the bankruptcy court for an order designating those amounts as administrative expenses. The process was cumbersome and time-consuming. Moreover, the landlord's efforts to get paid were hampered by the standards applied in determining what qualifies as a priority expense of administering a bankruptcy estate.

Section 503(b)(1) of the Bankruptcy Code provides that allowed administrative expenses include "the actual, necessary costs and expenses of preserving the estate." Rent payable under an unexpired commercial lease during a bankruptcy case arguably falls into this category. Even so, section 503(b)(1) has uniformly been interpreted to require that in addition to being actual and necessary, an expense must benefit the bankruptcy estate to qualify for administrative priority. Prior to the enactment of section 365(d)(3), "benefit to the estate" in this context was determined on a case-by-case basis by calculating the value to the debtor of its "use and occupancy" of the premises, rather than looking to the rent stated in the lease. Moreover, even if a landlord's claim for postpetition rent was conferred with administrative priority, the Bankruptcy Code did not specify when the claim had to be paid.

Section 365(d)(3) was designed to remedy this problem. It requires a trustee or DIP to remain current on lease obligations pending assumption or rejection of a lease. Nevertheless, courts have struggled with the precise meaning of the provision. For example, courts are at odds over whether the phrase "all the obligations of the debtor . . . arising from and after the order for relief" means: (i) all obligations that become due and payable upon or after the filing of a petition for

bankruptcy; or (ii) obligations that “accrue” after filing the bankruptcy petition. The former approach—commonly referred to as the “performance” or “billing date” rule—has been adopted by some courts. *See, e.g., Centerpoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205 (3d Cir. 2001); *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986 (6th Cir. 2000); *HA-LO Indus., Inc. v. Centerpoint Props. Trust*, 342 F.3d 794 (7th Cir. 2003). The second approach is sometimes referred to as the “proration” or “pro rata” approach. According to this view, real estate taxes and other nonrent expenses that accrue in part prior to a bankruptcy filing but are payable postpetition are akin to “sunken costs” that need not be paid currently as administrative expenses pending a decision to assume or reject the lease. *See, e.g., In re Treasource Indus., Inc.*, 363 F.3d 994 (9th Cir. 2004); *In re Handy Andy Home Improvement Ctrs.*, 144 F.3d 1125 (7th Cir. 1998).

Section 365(d)(3) has also been controversial in cases where the timing of a bankruptcy filing creates “stub rent.” Stub rent is the rent that is due for the period following the bankruptcy petition date until the next rent-payment date. For example, if a lease calls for the prepayment of rent on the first of each month, and the petition date falls on the 10th day of the month, assuming that rent was not paid prior to the petition date, the stub-rent period would be from the 10th day of the month through the end of the month. Because section 365(d)(3) requires current payment of obligations “arising from and after the order for relief,” it could be argued that stub rent need not be paid under section 365(d)(3) because the payment was due prior to the petition date. Some courts have rejected this approach, ruling that section 365(d)(3) requires a debtor to pay stub rent on a prorated basis as part of its duty to “timely perform” its obligations arising under its

unexpired leases. Other courts reject this interpretation, holding that stub rent need not be paid under section 365(d)(3).

Courts also disagree whether section 365(d)(3), rather than section 503(b)(1), is an appropriate basis for conferring administrative priority on (as distinguished from requiring performance of) a postpetition-lease obligation. For example, in *In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010), the Third Circuit ruled that section 365(d)(3) does not supplant or preempt section 503(b)(1). The court concluded that the DIP's use of the leased premises postpetition to produce income provided an "actual and necessary" benefit to the estate and that commercial landlords were thus entitled to stub rent as an administrative expense. Other courts have held that section 365(d)(3) provides authority to confer administrative status on a claim independent of section 503(b)(1). *See, e.g., In re The Leather Factory Inc.*, 475 B.R. 710 (Bankr. C.D. Cal. 2012).

By its terms, section 365(d)(3) requires performance of all postpetition "obligations" under an unexpired commercial lease, not merely the payment of postpetition rent, pending the trustee's decision to assume or reject. Whether an obligation other than payment of rent should be treated as an administrative expense was among the issues addressed by the Delaware bankruptcy court in *Mervyn's*.

Mervyn's

In January 2008, Mervyn's Holdings, LLC, and certain affiliates (collectively, the "debtors"), operators of a California-based department-store chain, leased commercial property in San Bernardino, California, from WM Inland Adjacent LLC ("Inland"). The debtors also entered into

a separate construction agreement with Inland governing prospective improvements to the leased premises. Both agreements contained provisions requiring the debtors to indemnify Inland for various liabilities arising prior to, during, and after the lease term. These obligations included a duty to keep the premises free of mechanics' liens and to pay all amounts, charges, and attorneys' fees due under the lease.

The debtors later entered into a separate agreement with contractor Fisher Development Inc. ("Fisher") to provide labor and materials for building improvements to the leased premises. The debtors filed for chapter 11 protection in Delaware in July 2008 while construction was still underway.

Fisher reacted to the bankruptcy filing by stopping all work on the premises and by filing two mechanics' liens against the property to secure claims aggregating \$5.5 million. Fisher then filed suit against Inland in October 2008 to foreclose on the liens. To settle the case, Inland agreed to pay Fisher approximately \$1.8 million in February 2010.

The debtors rejected the lease effective November 21, 2008. Inland filed two proofs of claim for amounts due under the lease and the construction agreement. Inland sought administrative priority under section 365(d)(3) for the \$1.8 million paid to Fisher under the indemnification provisions of the lease and construction agreements.

Inland maintained that the indemnity claim arose postpetition and prior to rejection of the lease and was therefore entitled to administrative priority pursuant to section 365(d)(3). According to Inland, the indemnity-claim obligation arose either when Fisher's liens were recorded or when Fisher sued the landlord, both of which occurred postpetition prior to rejection of the lease.

Inland cited *Montgomery Ward* as authority for the proposition that section 365(d)(3) creates administrative expense priority, in the context of unexpired commercial leases, for “all obligations that arise after an order for relief is entered and before the lease is rejected.”

The debtors countered with four principal arguments. First, they maintained that the indemnity claim arose from rejection of the lease and was therefore a prepetition unsecured claim pursuant to section 502(g). Second, citing *Jeld-Wen, Inc. v. Van Brunt (In re Grossman’s Inc.)*, 607 F.3d 114 (3d Cir. 2010), for the proposition that common-law and statutory claims arise when the conduct giving rise to the injury occurs, rather than when the injury manifests, the debtors argued that the indemnity-obligation claim arose when they and Inland entered into the lease and construction agreements and derived from prepetition improvements to the premises by Fisher, both “billing dates” prior to the bankruptcy-petition date. Third, the debtors asserted that there is no precedential authority applying *Montgomery Ward* to a lease-indemnification claim, and contrary precedent indicates that indemnification obligations in executory contracts should be treated as prepetition unsecured claims. Fourth, the debtors argued that, even if *Montgomery Ward* applies and the indemnification obligation arose postpetition, Inland cannot meet its burden under section 503(b)(1).

The Bankruptcy Court’s Ruling

The bankruptcy court granted summary judgment in favor of Inland. Addressing the debtors’ first argument, the court noted that “the damages arose from the filing of mechanics’ liens against the [p]remises,” rather than from rejection of the lease. Next, the court concluded that the argument that the debtors’ contractual obligation to indemnify Inland arose prepetition “runs

counter to the holding in *Montgomery Ward*” because it ignores the meaning of the term “obligation” in section 365(d)(3).

“In the context of section 365(d)(3),” the court wrote, “the relevant time is when an ‘obligation’ arises, which is different from when a ‘claim’ arises.” In *Montgomery Ward*, the court explained, the Third Circuit distinguished a “claim,” which is “an unmatured right to payment,” from an “obligation,” which is “something one is legally required to perform under the terms of the lease.” According to the court in *Mervyn’s*, the indemnity obligation arose when Fisher filed the mechanics’ liens and sued Inland, rendering the obligation legally binding under the lease.

Addressing the debtors’ third argument, the court reasoned that “the strictures of the analyses by the Third Circuit Court of Appeals are not inapplicable merely because this question has not yet been posed.” “The issue is one of first impression,” the court wrote, “and the Court is both guided and constrained by the holdings of *Montgomery Ward* where the Court of Appeals determined that such obligations in nonresidential real property leases fall under section 365(d)(3).”

The court also rejected the debtors’ argument that the indemnification claim was not entitled to administrative treatment because it did not confer a substantial benefit on the estate, as required by section 503 of the Bankruptcy Code. The court explained that section 503(b)(1) sets forth a two-part test for whether a claim is entitled to administrative priority: (i) the expense must have arisen from a postpetition transaction involving the debtor; and (ii) the transaction must have substantially benefited the estate.

Even so, the court concluded that Inland’s claim was not subject to this two-part administrative expense test. Because the express language of section 365(d)(3) includes the clause “notwithstanding section 503(b)(1),” the court reasoned, section 365(d)(3) “creates a new and different obligation—one that does not necessarily rest on the administrative expense concept.” According to the court, “The phrase operates as a ‘carve-out’ *exempting* these expenses from ‘the usual burdens and procedures’ ” (citing *Goody’s*). Therefore, the court ruled that, because the indemnification claim stemmed from a postpetition obligation under section 365(d)(3), “section 503(b)(1) is inapplicable.”

Finally, the court was not persuaded by the debtors’ argument that “applying the section 503(b)(1) exemption set forth in *Goody’s* creates bad public policy” because elevating Inland’s claim to administrative status “simply by conspiring with a third-party plaintiff” would encourage “a wait-and-see hedging of bets regarding an anticipated bankruptcy.” “This is not gamesmanship among pre-petition unsecured creditors,” the court wrote, concluding that its holding “fits squarely” into section 365(d)(3) and the rationale of *Montgomery Ward*.

Outlook

Mervyn’s is a logical application of section 365(b)(3) and applicable case law. However, it does create the potential for doubt about certain claims that may appear to be unsecured, prepetition claims. The decision suggests that although a claim may exist before bankruptcy, if the obligation to pay arises postpetition, it may be treated as an obligation which must be paid immediately under section 365(d)(3). Any potential increase in such payment obligations could make it a challenge for some debtors to reorganize successfully. One of the effects of the decision may be that a DIP or trustee might be forced to accelerate the decision to assume or

reject an executory contract or unexpired lease to minimize the risk that a postpetition, prerejection “obligation” will create a substantial immediate-payment obligation.

The court in *Mervyn’s* was careful to point out that, in its view, the landlord and the contractor were not engaging in “gamesmanship” which would justify denial of the landlord’s request as a matter of public policy. However, the story might be otherwise in other cases—it is not difficult to imagine an astute landlord making a strategic decision to time the assertion of claims for obligations due under a lease in a way designed to maximize its recovery in 100 cent dollars.