

Bankruptcy Court Splits the Baby on Real Estate Landlord's Claim for Unpaid Postpetition Rent

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In this article, the authors explain that a Chapter 7 trustee-lessee's failure to comply with postpetition, pre-rejection lease obligations does not automatically give the landlord an administrative expense claim, as some courts fashion alternative remedies on a case-by-case basis.

In *In re Jughandle Brewing Co. LLC*,¹ the U.S. Bankruptcy Court for the District of New Jersey faced the following question: whether, in a Chapter 7 case, postpetition, pre-rejection payments due under an unexpired lease of nonresidential real property must be treated as an administrative expense claim under Bankruptcy Code Section 503(b)(1), regardless of whether the rent payments were actual, necessary costs of preserving the estate. It answered the question in the negative, holding that there is no per se rule that a trustee's obligation to perform postpetition lease obligations under Section 365(d)(3) creates an administrative expense claim.

And on the facts before it, the court crafted a middle ground, allowing an administrative expense claim in favor of the landlord in an amount equal to three months of base rent less amounts paid to the landlord by the secured creditor as a use and occupancy fee for removal of its collateral, along with a general unsecured claim for prorated stub rent for

the initial postpetition period. In so doing, the court confirmed that courts may craft an appropriate remedy when a trustee or debtor in possession breaches a real estate lease before rejection on a case-by-case basis.

BACKGROUND

Jughandle Brewing Company LLC (Debtor) and landlord Eight Star LLC (Landlord) were parties to an unexpired prepetition lease (Lease) for real property located in Tinton Falls, New Jersey (Property). OceanFirst Bank, a secured creditor (Creditor), held an undisputed prepetition lien on the Debtor's personal property located at the Property.

On July 3, 2023, the Debtor filed for Chapter 7 relief under the Bankruptcy Code. A Chapter 7 trustee (Trustee) was appointed shortly thereafter. Within the first 60 days of the case, the Landlord and Creditor each filed motions for relief from stay, as to the Lease and the personal property collateral of the Creditor,

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respectively. The motions were granted, and the Landlord and Creditor were free to pursue their remedies, with the Creditor obtaining access to the Property to dispose of its collateral in exchange for a fee paid to the Landlord, and the Landlord obtaining a judgment in state court for possession of the Property.

With stay relief granted, the Trustee took no action regarding the Property, neither moving to assume or reject the Lease nor paying any postpetition rent to the Landlord. At the same time, despite ongoing communications regarding the Property and a process by which the Creditor could liquidate its collateral, the Landlord, who never demanded payment of postpetition rent, led a motion to compel the Trustee to reject the Lease or sought to compel the payment of rent. After 120 days, the lease was automatically rejected by operation of law pursuant to Section 365(d)(4)(A)(i).

Shortly before the expiration of the 120-day period, the Landlord moved to compel the payment of rent as an administrative expense for the postpetition, pre-rejection period. The Trustee objected, relying on Section 503(b)(1), arguing that the Lease had provided no benefit to the estate - the Debtor was not operational, and the Trustee had no claim to the collateral stored at the Property. The Trustee subsequently led a cross-motion for an order rejecting the Lease nunc pro tunc to the petition date, based upon equitable grounds.

ADMINISTRATIVE EXPENSES AND UNEXPIRED LEASES

The bankruptcy court first conducted an analysis of Section 503(b)(1), which accords administrative expense priority status to a claim only if it contributes to the actual, necessary costs and expenses of preserving the

estate. The court observed that designation of a claim as an administrative expense has certain benefits, as claims allowed under Section 503(b) are entitled to priority over general unsecured claims. The court further noted it is generally accepted that Section 503(b) must be narrowly construed.

The court then analyzed Section 365(d)(3) of the Bankruptcy Code, which requires a trustee or debtor in possession to timely perform all postpetition obligations of the debtor arising under any unexpired lease of nonresidential real property, until the lease is assumed or rejected, notwithstanding Section 503(b)(1). The court observed that, while Section 365 imposes an obligation to pay postpetition rent, it makes no mention of the consequences for failure to do so.

MAJORITY AND MINORITY VIEWS

The bankruptcy court recognized that the majority of courts hold that where a trustee fails to perform under Section 365(d)(3), allowance of an administrative expense claim is the presumed remedy. The *Jughandle* court, while generally agreeing with the reasoning of the majority view, stated that it did not believe that the allowance of an administrative claim was the sole remedy available for violations of Section 365(d)(3).

The *Jughandle* court went on to discuss that a minority of courts have addressed violations of Section 365(d)(3) through other means, including by allowing lease rejection, allowing an administrative rent claim in a reduced amount, and by relying on Section 105(a) (a catch-all provision which provides bankruptcy courts with the power to issue any order necessary or appropriate to carry out the provi-

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sions of Title 11) to direct the payment of postpetition rent.

After reviewing applicable case law, discussing congressional intent (had Congress intended for an administrative expense to be the exclusive remedy for a violation of § 365(d)(3), it would have set forth such relief within the statute), applying a logical reading of the statute, and noting that the U.S. Court of Appeals for the Third Circuit has no established precedent as to a required remedy for a Section 365(d)(3) violation, the bankruptcy court determined that (i) allowance of an administrative claim under Section 503(b) is not the exclusive remedy for a postpetition, pre-rejection failure to perform lease obligation, and (ii) the court may craft an appropriate remedy using its equitable powers under Section 105(a).

THE BANKRUPTCY COURT'S REMEDY

Before crafting a remedy, the bankruptcy court addressed two issues raised by the Trustee: (1) whether Section 365(d)(3) is treated differently in Chapter 7 cases versus Chapter 11 cases, and (2) whether the Lease should be retroactively rejected to the petition date.

On the first issue, the court noted that the structure of Section 365 does not support a different application of Section 365(d)(3) in Chapter 7 cases versus Chapter 11 cases. For example, Sections 365(d)(1) and (d)(2) each have different timeframes during which leases of residential real property are deemed rejected in a Chapter 7 versus a Chapter 11. Although Congress could have made a similar distinction for nonresidential real property leases, it did not.

On the second issue, the court noted that in the Third Circuit, retroactive rejection of a lease is only used in exceptional circumstances and is dictated by equitable considerations. After evaluating the parties' arguments, the court ultimately found that the facts of the case were far from the exceptional circumstances required to order retroactive rejection *nunc pro tunc* to the petition date.

In shaping its remedy, the *Jughandle* court took a middle ground approach, finding that, based on the facts and equities of the case, allowance of a reduced administrative expense claim was the appropriate remedy. The facts supported that the Lease offered no benefit to the estate and that there were no other tenants covering the cost of services provided by the landlord in this case, so the legislative intent behind Section 365(d)(3) did not apply to the Lease. The court therefore allowed the Landlord an administrative claim in the amount of base rent for three months, less any amounts paid to the Landlord by the Creditor for access to the Property.

Regarding the stub rent (i.e., the portion of the monthly rent that became due prepetition but is attributable to the initial occupancy period immediately following the petition date), because the Landlord sought that portion of its claim under Section 503(b)(1) (and not Section 365(d)(3)) and failed to provide evidence that the stub rent was an actual or necessary expense of preserving the estate, the court allowed only a general unsecured claim. Finally, the Landlord's claim for late fees and interest was flatly denied.

IN SUMMARY

- When a trustee or debtor in possession

fails to perform its postpetition, pre-rejection lease obligations, most courts presumptively grant the landlord administrative expense treatment under Section 365(d)(3).

- A minority of courts, however, require that a landlord show the benefit to the estate under Section 503(b)(1) from the use of the property prior to being granted administrative claim status.
- If postpetition lease obligations are not being met, a landlord should consider promptly demanding the payment of rent, filing a motion to compel the payment of rent, and/or filing a motion to compel the trustee to assume or reject the lease to minimize the impact of the minority rule.

CONCLUSION

Even though *Jughandle* was a Chapter 7 case, the court made clear that its reasoning applies equally in Chapter 11 cases. To mitigate against the possibility that a court will not presumptively hold that claims for pre-rejection breach give rise to administrative expense claims, landlords whose tenants file under either chapter should undertake measures early

to press their rights. While some courts have refused to force trustees to immediately pay rent despite what the Bankruptcy Code says, landlords should nevertheless consider demanding prompt payment and seeking alternative relief to compel the payment of rent and/or to compel the trustee to assume or reject the lease. Asserting these rights may tip the balance of the equities in favor of a landlord administrative expense claim based on the lease terms when a trustee or debtor seeks to limit that claim to the benefit received by the estate postpetition and pre-rejection. Landlords also should consider prebankruptcy options to mitigate the risk that lease obligations will not automatically receive administrative expense status postpetition and pre-rejection, including taking a larger security deposit, obtaining a letter of credit to cover at least some portion of a claim or obtaining a personal guaranty, which could provide landlords with an extra layer of protection in the event of any future lease rejection.

NOTES:

¹In re *Jughandle Brewing Company, LLC*, 2024 WL 2819626 (Bankr. D. N.J. 2024).