

# Bankruptcy Risks to Landlord When Tenant Files a Bankruptcy Case

A Lexis Practice Advisor® Practice Note by Ira L. Herman, Blank Rome LLP



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This practice note discusses the risks to the landlord when a tenant files for bankruptcy and the steps a landlord can take to protect itself following a tenant's bankruptcy filing.

Once a tenant enters a Chapter 11 bankruptcy case and becomes a debtor-in-possession, it has the option of assuming (and perhaps assigning) or rejecting its unexpired lease. If a lease is assumed, the lease continues in full force and effect, and any defaults by the debtor must be cured and damages compensated. If the debtor tenant also assigns the lease, the landlord would acquire a new tenant. Where an unexpired lease is deemed rejected, the Bankruptcy Code provides that the debtor tenant shall surrender the premises and the landlord shall have a claim for rejection and other damages, as well as a possible claim for post-petition rent. In negotiating the terms of a lease, a landlord should therefore try to maximize the debtor tenant's obligations to cure any rental payment defaults under an assumption (and to compensate for any other damages). The landlord should also try to maximize its claim under a rejection.

This practice note addresses these issues and landlord risks in a tenant bankruptcy as follows:

- Lease Status and Risk of Recharacterization
- Maximizing Debtor's Obligation to Cure If Lease Is Assumed
- Maximizing the Claim Amount If the Debtor Tenant Rejects the Lease

- Maximizing Landlord Recovery for Debtor's Obligations Arising after the Bankruptcy Case Begins

For a discussion of the possible effects of a landlord's bankruptcy on a tenant, see [Bankruptcy Risks to Tenant When Landlord Files a Bankruptcy Case](#). For further guidance and detailed discussions of assumption, assignment, and rejection, including special timing rules for commercial leases and an explanation of how, notwithstanding any contractual term precluding assignment, an unexpired lease generally may be assigned, subject to certain limitations (and a requirement that the debtor-assignor supply adequate assurance of the assignee's future performance), see [Assumption, Assignment, and Rejection of Executory Contracts, Special Considerations for Assumption, Assignment, and Rejection of Certain Executory Contracts](#) and Collier Lending Institutions & Bankruptcy Code P 3.03. For information and resources on retail bankruptcies, see [Retail Bankruptcies](#) and [Retail Industry Bankruptcy Resource Kit](#).

## Lease Status and Risk of Recharacterization

Assumption, assignment, and rejection issues in bankruptcy are moot where a lease is not considered unexpired as of the petition date. Section 365(c)(3) of the Bankruptcy Code provides that the debtor-in-possession or trustee may not assume or assign an unexpired lease of nonresidential real property if such lease has been terminated under applicable non-bankruptcy law before the petition date. The lease's status under state law and the terms of the lease determine whether the lease has been terminated for purposes of assumption and assignment. For example, under New York law, even though no execution on a warrant of eviction occurred, the lease nevertheless was deemed terminated

pre-petition by judgment of possession and warrant. In re Association of Graphic Communications, Inc., 2011 U.S. Dist. LEXIS 35702 (S.D.N.Y. March 31, 2011). However, it should be noted that post-petition payment of rent by the tenant and efforts to reinstate the lease may support a reinstatement of a lease that is terminated pre-petition. In re Sweet N Sour 7th Ave. Corp., 431 B.R. 63 (Bankr. S.D.N.Y. 2010).

An ipso facto clause grants a party the right to terminate a contract based upon the insolvency or financial condition of the other party, the other party's commencement of a bankruptcy case, or the appointment of a trustee or receiver or other custodian over the property of the other party. These ipso facto clauses are not enforceable in a bankruptcy case. See Section 365(e)(1) of the Bankruptcy Code; [Assumption, Assignment, and Rejection of Executory Contracts: Special Considerations for Assumption, Assignment, and Rejection of Certain Executory Contracts](#); and Collier Lending Institutions & Bankruptcy Code P 3.03[2] [b][i]. Nevertheless, landlords should consider retaining such clauses in lease agreements. Though ipso facto clauses are not enforceable during a bankruptcy case, they remain enforceable after a bankruptcy case has been dismissed or closed, for example where a reorganization plan is denied confirmation. At such a point, the option to terminate and get out of an unfavorable lease is something a landlord would value highly.

### **Lease Recharacterization as a Risk of Bankruptcy with Respect to Real Property**

Should an entity file for bankruptcy relief, its capital provider has very different rights when the transaction is determined to be a mortgage loan as opposed to it being a true real property lease. Whether the transaction is a true lease or a mortgage, the capital provider will be stayed from taking enforcement actions by virtue of the automatic stay upon the commencement of a bankruptcy case. If the transaction is determined to be a mortgage, then the creditor will generally not receive any payments during the pendency of the bankruptcy case (other than possible adequate protection payments, under Section 361 of the Bankruptcy Code and Section 362 of the Bankruptcy Code, but only if specifically authorized by the bankruptcy court). Ultimately, the creditor will be entitled to receive payments with a present value (as determined by the court) equal to the value of its interest in the collateral. Thus, the amount and timing of the payments and the interest rate on the debt can be rewritten in the bankruptcy case. If the debt exceeds the value of the collateral, the creditor will receive an unsecured claim for the difference, which may result in a payment of only pennies on the dollar for that portion of the claim.

If the transaction is considered a lease for nonresidential real property, however, the estate will be required to either assume or reject the lease. If the estate elects to assume the lease, it must cure defaults and provide adequate assurance of future performance of the lease terms. To retain the property, the estate will have to honor its lease obligations, including paying rent during the administration of the bankruptcy case (subject to any exceptions to the general rule contained in Section 365 of the Bankruptcy Code). If the estate rejects a lease, the lease is treated as having been breached, and the leasehold must be turned over to the lessor, who may then file an unsecured claim for damages, subject to a statutory cap. The estate does not have the option of delaying payments while the bankruptcy case is pending, nor can it rewrite the payment terms on the lease pursuant to a plan of reorganization, as may be done in the appropriate circumstances with a mortgage. For more information about executory contracts and unexpired leases, see [Assumption, Assignment, and Rejection of Executory Contracts](#).

The rules that bankruptcy courts use for distinguishing between a true lease and mortgage transactions will affect the terms and documentation of most deals, as lawyers advise their clients on the optimal ways to protect their interests. Section 365(d)(3) of the Bankruptcy Code and Section 365(d)(4) of the Bankruptcy Code apply solely to "true" or "bona fide" leases. The designation of an agreement as a lease is not controlling. Instead, the court generally will look to the parties' intent in order to determine if the agreement is a lease, a financing arrangement, a joint venture agreement, a mortgage, a management agreement, or some other type of agreement. For example, in *In re LeFrak*, 223 B.R. 431 (S.D.N.Y. 1998), a debtor-shareholder's 99-year proprietary lease for a cooperative apartment unit was deemed to be not a true lease that needed to be assumed or rejected since the debtor's interest was more in the nature of a deed to real property. This would apply in the nonresidential context as well (e.g., commercial office cooperatives). Overall, the question of whether a lease is found to be a true lease will depend on applicable state law.

## **Maximizing Debtor's Obligation to Cure If Lease Is Assumed**

The cure rule for assuming an unexpired lease is the same as it is for assuming all other executory contracts: such agreements may not be assumed unless at the time of assumption the trustee (or debtor-in-possession) "cures, or provides adequate assurance that the trustee will promptly

cure, such default . . .” Section 365(b)(1) of the Bankruptcy Code; see Collier Lending Institutions & Bankruptcy Code P 3.03[4] for additional information. For example, the cure obligation applies squarely to a tenant’s pre-assumption defaults on obligations to pay rent, taxes, utility charges, late charges, interest, attorneys’ fees and other monetary obligations due under the lease, as well as damages resulting from defaults of nonmonetary obligations. See Section 365(b)(1) of the Bankruptcy Code.

The lease terms that will maximize the debtor tenant’s obligation to cure and compensate the landlord for damages upon a debtor tenant’s assumption of the lease would both (1) expressly characterize any failure of the debtor to perform listed nonmonetary obligations as “defaults that, for a valid assumption of the lease to occur in a case under the Bankruptcy Code in which the tenant is a debtor, must be cured pursuant to Section 365 of the Bankruptcy Code” and (2) either monetize the value of such listed nonmonetary obligations or provide a formula for doing so, but which also do not restrict a landlord’s claim for actual damages from such defaults. Thus, upon a debtor tenant’s motion to assume the lease (or to have such assumption accomplished in the course of an assignment to the party that purchases the debtor’s assets in a bankruptcy case), the landlord may object to such assumption if the tenant debtor has failed to cure a default in payment of rent and damages are required to be paid to landlord pursuant to Section 365 (b)(1).

See [Tenant Bankruptcy Lease Provisions \(Pro-Landlord\)](#) for certain lease terms a landlord might propose to effectuate an appropriate cure by a debtor tenant and compensation for damages in the context of an assumption of the lease. The same drafting principles apply to the context of an assumption and assignment of the debtor tenant’s lease rights to a third party, including in a sale of the debtor’s assets. See [Selling Assets and Assigning Contracts and Leases in a Section 363 Sale](#).

## Maximizing the Claim Amount If the Debtor Tenant Rejects the Lease

A trustee or debtor-in-possession must reject or assume an unexpired lease of commercial real property within 120 days after the bankruptcy petition date (or upon an earlier confirmation of a plan) or rejection will occur automatically, per Section 365(d)(4)(A)(i) of the Bankruptcy Code. The period may be extended for an additional 90 days for cause. See Section 365(d)(4)(A)(ii) of the Bankruptcy Code. For a form extension motion, see [Motion to Extend the Time to Assume or Reject Nonresidential Real Property Leases](#).

Pursuant to Section 365(g) of the Bankruptcy Code, rejection of a lease is treated as a breach of the lease occurring immediately before the petition date and entitles the landlord to damages as determined pursuant to state law. However, the part of the claim relating to future rent is capped by a formula set forth in Section 502(b)(6)(A) of the Bankruptcy Code. In short, the cap is set at the unpaid rent from the earlier of the petition date or the date the landlord repossessed the premises, plus the greater of (1) one year’s rent or (2) 15% of the rent owing (not to exceed three years’ worth of rent). The cap may be construed as not applying to damage claims which are not based upon rent. Thus, the rejection claim of a tenant would be maximized where the tenant includes terms in the lease as described above for maximizing cure and damages compensation in the context of an assumption. Further, the cap applies to limit a landlord’s claim against a debtor guarantor who guarantees a tenant’s rent obligations under the lease. In *re Farley, Inc.*, 146 B.R. 739, 745 (Bankr. N.D. Ill. 1992).

Security deposits held by the landlord are most often applied to reduce the rejection damages to which a landlord is entitled under the Section 502(6)(A) cap, but not to reduce other damages. In *Solow v. PPI Enters.*(U.S.) (In *re PPI Enters.* (U.S.)), 324 F.3d 197 (3d Cir 2003), the Third Circuit Court of Appeals cited this as the majority rule, and even extended it to letters of credit that function as a security deposit. In contrast, the Fifth Circuit Court of Appeals, in *EOP-Colonnade of Dallas Ltd. P’ship v. Faulkner* (In *re Stonebridge Techs., Inc.*), 430 F.3d 260 (5th Cir. 2005), held that the proceeds from a letter of credit drawn on by the landlord cannot be counted against the cap as applied to rejection damages under Section 502(b)(6)(A). The Court reasoned that the cap applies to limit a claim against the debtor and that, due to the independence principle applied to letters of credit, the draw is not payment on such a claim.

## Maximizing Landlord Recovery for Debtor’s Obligations Arising after the Bankruptcy Case Begins

Debtor tenants must pay their rent post-petition. Section 365(d)(3) of the Bankruptcy Code requires a debtor to pay full contract rent when due (as well as fulfill other obligations under the lease, including those regarding maintenance, repair, taxes, and insurance) until the court enters an order approving the rejection of the lease.

Section 365(d)(3) of the Bankruptcy Code provides that the trustee (or debtor-in-possession, if applicable) “shall timely perform all the obligations of the debtor” arising after the

petition is filed and before the lease is assumed or rejected. Section 365(d)(3), by its terms, does not condition the landlord's right to payment on the use of the property by the bankruptcy estate. The trustee or debtor-in-possession is required only to comply with the tenant's lease obligations (i.e., pay rent) in a timely fashion during the post-petition/pre-rejection or assumption period. Notwithstanding the apparently clear language of the statute, issues have arisen, among other things, regarding the amount of the payments due to the landlord during such period and the timing of such payments.

The majority view is that a landlord is entitled to payment of the rent reserved by the lease for the period after the filing of the petition and prior to rejection or assumption of the lease whether or not the debtor has vacated the property. This view is predicated on a plain reading of the statute and on considerations of fairness to the landlord, as the landlord is forced to allow the tenant to occupy its leasehold, whether it is office space or other commercial space, and pay expenses despite continuing default by the tenant. According to this view, if the trustee or debtor-in-possession vacates a leasehold but fails to reject a lease, the estate is liable for rent until the lease is rejected. In many cases, a trustee will seek to avoid the rent claim by asserting that the lease was terminated by the landlord's actions prior to the filing of the petition or by advocating a minority view that payments to landlords must meet the criteria for administrative expenses set out in Section 503(b)(1) of the Bankruptcy Code. Thus, many courts have held that nonresidential lessors are entitled to immediate payment of rent reserved and not the actual or necessary cost of preserving the estate during a pre-assumption or rejection period even if the rent reserved is above or below market.

## Stub Rent

When a tenant files a voluntary bankruptcy case, payment of post-petition rent is one of the first issues facing the parties with respect to an unexpired lease. See [Tenant Bankruptcy Lease Provisions \(Pro-Landlord\)](#). Debtor/tenants are required to timely perform their post-bankruptcy obligations under their commercial leases. Should a tenant file a bankruptcy petition mid-month, such filing has the effect of splitting the month in two. First, there is the portion of the month elapsing prior to the filing, and, second, there is the portion of the month elapsing while such debtor/tenant and its assets are subject to the jurisdiction of the bankruptcy court. Courts are divided on the issue of the payment of the post-petition date stub rent that arises when (1) there is a mid-monthly period filing, and (2) a lease calls for payment of rent in advance (i.e., on the first day of each consecutive month during the term of a lease, and a bankruptcy filing takes place mid-month).

One line of case provides that the landlord is entitled to a full month of rent, even though the Chapter 11 debtor rejected and vacated the subject leasehold on the second day of such month. In *re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000).

The stub rent issue has been heavily litigated around the country. The two approaches often are referred to as the billing date approach (sometimes referred to as the performance approach) and the proration approach. However, even courts applying the billing date approach differ concerning the entitlement of a landlord to the timely payment of stub rent. The billing date focuses on the due day on which the rent falls due. Under this approach, if rent is due on the first of the month and the tenant files later in the month, none of the rent for the affected month is considered a post-petition obligation subject to the pay as you go requirement of Section 365(d)(3) of the Bankruptcy Code. Thus, courts employing the billing date approach will reason that if the rent is due on the first day of the month and a bankruptcy filing occurs mid-month, the landlord is not entitled to the immediate payment of the stub rent pursuant to Section 365(d)(3) for the portion of the month elapsing after a bankruptcy has been filed. In contrast, courts employing the proration approach will find that the monthly rental obligation is to be allocated on a per diem basis for each day of the affected month. Thus, a bankruptcy filing on the 15th day of a month would create stub rent immediately payable under Section 365(d)(3) for the second half of such month. Generally, landlords favor the proration approach, and tenants that are attempting to husband their cash prefer the billing date approach.

## Additional Rent Charges

There is a split of authority regarding attorneys' fees incurred by a landlord acting to compel a debtor/tenant to timely pay rent accruing during the post-petition/pre-rejection period. The legal issue that the courts focus on is whether such fees are deemed to be rent or additional rent under the provisions of the lease. In light of the express statutory language requiring a trustee to comply with a debtor's lease obligations and the ability of the trustee or debtor to avoid liability for attorneys' fees by complying with the statute, the better view, at least from the landlord's perspective, will be to allow recovery of such attorney's' fees as an administrative expense.

Another issue arising with respect to the additional rent concerns the payment of taxes, common charges, base rent, and similar expenses that may have accrued prior to the filing of the bankruptcy petition but that were billed after the filing. Are these expenses to be treated as post-filing/pre-rejection lease obligations that must be paid in full under

Section 365(d)(3) of the Bankruptcy Code (based on the billing or performance date), or are they treated as part of the landlord's pre-petition claim for damages (based on the period to which the charges relate)? Courts historically opted to prorate such charges according to the period to which they related, without regard to the billing date. Notably, the Third and Seventh Circuits are in conflict on the issue. See *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001) (rejecting proration arguments); *Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998) (accepting proration arguments).

The analysis by so-called proration courts focuses on considerations of fairness and specifically on the reason that it would be unfair to permit a landlord to recover pre-petition damages simply because they are billed during the post-petition/pre-rejection period when other creditors are not protected in the same way. Such courts take the view that Section 365(d)(3) of the Bankruptcy Code is inapplicable to stub rent since the obligation in question arose prior to the petition filing date. The burden is being placed on a landlord under such circumstances to pay unfunded pre-petition operating expenses while additional operating expenses are accruing post-petition, without any assurances that any of the expenses actually will be funded by the payment of amounts due under its lease.

On the other hand, billing date courts take a more literal approach to Section 365(d)(3) and reason that if a lease requires payment of such charges during the post-petition/pre-rejection period, the debtor or trustee is required to make such payments. This approach seems more consonant with the purposes of Section 365(d)(3) of the Bankruptcy Code, which was adopted to ensure that landlords receive the rent to which they are entitled during the post-filing/pre-rejection period, as they are forced by law (rather than their own independent business decision) to continue to lease space to the bankrupt tenant. Practitioners should note that the billing date approach does not always work in favor of the landlord.

The same issue (billing date vs. proration) will arise with respect to fixed rent if the tenant rejects the lease shortly after the date on which the fixed rent becomes due. Should the landlord receive pre-petition rent for the full month or just a prorated amount calculated on the number of days of the month during which the tenant is in possession? In this situation, courts are more likely to follow the billing date approach.

A related question is what happens if the tenant files immediately after the base rent payment date (e.g., rent due on December 1st and the tenant files on December 2nd). Is the landlord limited to a pre-petition damage claim for that

month, or can the landlord recover a pro rata portion of the rent for that month as an administrative expense (i.e., from December 2nd through December 31st) rather than pre-petition damages? The landlord cannot seek payment under Section 365(d)(3) if the billing date approach applies, even though the tenant continues to occupy the premises. In that situation, some courts have held that the landlord is entitled to make a claim for the pro rata portion of the rent for the month in which the filing occurs as an administrative expense under Section 503(b)(1) of the Bankruptcy Code.

Since a landlord's claim for post-petition administrative rent generally ends when a lease is rejected, litigation also arises over the timing of rejection. Faced with a landlord's claim for post-petition/pre-rejection rent, a trustee who has failed to promptly reject a lease for unused space will generally argue that rejection occurred when the trustee or debtor first evinced the intention to reject (or when the debtor vacated the premises) or to seek a court order providing for a retroactive rejection date. Some courts permit retroactive rejection while others do not (discussed below). The landlord will generally argue that rejection only occurs at the end of the 120-day period (210-day if the trustee moves for an extension), or when the court issues an order of rejection (if the order is issued earlier than the expiration of the 120-day period).

### **Administrative Expense Claims**

All may not be lost for landlords finding themselves before courts that employ the billing date approach. Landlords may still seek payment of stub rent as an administrative expense claim under Section 503(b)(1) of the Bankruptcy Code which provides for the allowance of administrative expense claims for "the actual, necessary costs and expenses of preserving the [bankruptcy] estate." See *Goody's Family Clothing, Inc.*, 610 F.3d 812 (3d Cir. 2010). Of course, this is a heightened standard that a landlord must satisfy to be paid stub rent, as the landlord is required to prove that the rent being charged provided an actual benefit and was necessary to preserve the estate. See *Id.* However, some courts that apply the billing date approach view stub rent as part of a single pre-petition claim for an entire month's rent and thus not eligible for administrative expense treatment. See *In re Oreck Corp.* 506 B.R. 500 (Bankr. M.D. Tenn. 2014).

Generally, administrative expense claims are paid only in successful Chapter 11 cases and, absent appropriate circumstances, such claims are not paid until confirmation or consummation of a Chapter 11 plan (i.e., the end of the case). From a practical perspective, appropriate circumstances generally are instances where a vendor has the leverage of not providing goods or services that are otherwise unavailable to a debtor. Courts that are unsympathetic

to landlords may not be willing to view the landlord/tenant relationship as rising to the level of appropriate circumstances to support a landlord's request for an early payment of stub rent.

Should the trustee or debtor-in-possession assume a lease, all past due rents for the post-petition and pre-petition periods must be paid, including the stub period rent. On the other hand, if the debtor rejects the lease, under Section 502(d) of the Bankruptcy Code, the rejection claims will be treated as amounts becoming due before the petition date and will therefore be given the status of general unsecured claims.

A landlord may be able to recover the stub rent as an administrative claim if the landlord can show that the continued occupancy of the space after the filing date provided an actual benefit to the estate and that the stub pay was necessary to preserve the value. Thus, even in the most restrictive sense, a landlord may qualify for administrative expense treatment under Section 502(b)(1) of the Bankruptcy Code to allow for recovery of this stub rent. As a practical matter, where the tenant has extended its time to assume or reject a lease and the tenant remains in possession, courts have been sympathetic to landlord requests for immediate payment of rent.

Whatever the view of the presiding court, it is clear that a landlord whose tenant has filed for bankruptcy and defaulted in paying rent in the post-petition/pre-rejection period should immediately move to compel payment and/or move for relief from the automatic stay so that the landlord can commence a state court eviction action. If the landlord allows a post-petition rent claim to accrue, such landlord is proceeding at his, her, or its own peril because a court in such circumstances is apt to treat a claim for post-petition date rent arrearages as an administrative expense at the end of the case on parity with other administrative claimants, at which point there may be insufficient funds to pay the landlord's claim for post-petition rent.

### **Retroactive Rejection**

Although Section 365(d)(3) of the Bankruptcy Code requires a tenant to pay all obligations arising after the filing of the petition and prior to assumption or rejection, the tenant may be able to shorten the period during which a post-petition obligation may accrue by requesting that a court authorize the debtor-in-possession or trustee to reject the lease retroactively. Retroactive rejection can be an effective tool in a tenant's arsenal because, if the lease is rejected retroactive to the petition filing date, the landlord loses its right to collect rent under Section 365(d)(3). Although there is an issue as to

whether the courts may exercise such power in light of the express statutory requirement set out in Section 365(d)(3) that the landlord be paid, a number of courts have held that they have the power to order a retroactive rejection if the equities militate in favor of retroactive rejection.

In a 2007 case, the Second Circuit held that the landlord waived its right to object to retroactive rejection but expressly reserved decision on whether a bankruptcy court has equitable authority to order rejection retroactively. *Adelphia Business Solutions, Inc.*, 482 F.3d 602 (2d Cir. 2007). There is a division of authority on the timing of when the rent reserve must be paid to the landlord. Many courts take the view that the rent must be paid as it becomes due, even if the estate is insolvent (i.e., will be unable to pay all administrative claims at the end of the case), as the statute requires timely payment. Courts following this view have expressed a concern about the possible windfall to the trustee or debtor-in-possession if the trustee or debtor-in-possession is able to avoid the statutory timely payment requirement simply by failing to pay rent, thus leaving the landlord to collect the rent as an administrative expense from a possibly insolvent estate at the end of a case.

Other courts take the view that the rent should be paid immediately only if it appears that the estate will have sufficient assets to pay administrative claims in full. According to this view, if an estate may be administratively insolvent so that all post-bankruptcy claims may not be paid in full, the landlord may not be paid its post-petition/pre-rejection rent as scheduled by a lease. Instead, the landlord should only be paid at the conclusion of the case on a pro rata basis, with other administrative expenses out of the assets being made available for distribution. Courts adhering to this line of thought generally have relied on the below:

- Absence of any explicit super-priority language in the statute that would catapult the landlord's claim for rent in front of other administrative expenses –and–
- The availability of a number of effective remedies to the landlord if the trustee or the debtor-in-possession fails to pay post-petition/pre-rejection rent, including a motion to compel payment of rent, a motion to require the bankrupt to surrender the premises, a motion to lift the automatic stay to allow the landlord to proceed with an eviction action, and a motion to convert the case to Chapter 7

A third view is that rent is payable as specified in a lease, but the landlord may be required to disgorge post-petition/pre-rejection payment of rent if the estate is administratively insolvent at the end of the case.

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