

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

IN RE: CASE NO. 04-78434

Rhodes, Inc.,

CHAPTER 11

Debtor.

JUDGE MASSEY

NAP Chesterfield, L.P.,

Movant,

v.

CONTESTED MATTER

Rhodes, Inc.,

Respondent.

ORDER DENYING IN PART MOTION OF NAP CHESTERFIELD, L.P.
TO COMPEL DEBTOR TO PAY RENT UNDER AN
UNEXPIRED LEASE OF NONRESIDENTIAL REAL PROPERTY

NAP Chesterfield, L.P. leased to Rhodes, Inc., the Debtor in this Chapter 11 case, commercial real estate in Richmond, Virginia pursuant to a lease agreement dated in November 1997. NAP moves for an order requiring Rhodes to pay base rent for the months of April and May 2005 and other amounts due under the lease postpetition. (The Court approved Debtor's rejection of the lease as of June 22, 2005, and Debtor has agreed to pay June rent through the date of rejection.) Rhodes contends that its obligation for postpetition rent under the lease through May 2005 has been largely satisfied, although it concedes it still owes at least \$10,000.

The Court adopts as its findings of fact, the facts stated in the stipulation of the parties filed on June 14, 2005. In addition, the Court finds that "RoomStore always intended that [the

payments made by RoomStore to NAP during the pendency of the Rhodes bankruptcy case] would offset any obligations of Rhodes due under the Lease for the months of November, December, January, and February.” Affidavit of Brian D. Bertonneau sworn to on June 14, 2005, attached to the Memorandum of Rhodes, Inc. in Opposition to the Motion of NAP Chesterfield, L.P. to Compel Debtor to Pay Rent (Document No. 788). The Court held a hearing on the motion on June 16, 2005.

In 1999, Rhodes assigned its interest in the lease to Heilig-Meyers Furniture Company.

That Assignment Agreement provided in part:

The Assignee (a) accepts the assignment of all of the Assignor's right, title and interest in and to the Lease (b) agrees to be bound by all of the terms, covenants and conditions thereof and (c) assumes the obligations of the Assignor under the lease from and after the date hereof. The Assignee covenants and agrees to perform each term, covenant and condition directly for the benefit of the Landlord

In 2000, RoomStore and Heilig Meyers Furniture Company filed Chapter 11 bankruptcy cases in the Eastern District of Virginia. Subsequently, Heilig-Meyers Furniture Co. assigned its interest in the lease to HMY RoomStore, Inc., one of its affiliates, to which NAP consented. The base monthly rent (including CAM charges but subject to adjustment) under the lease is \$42,590.47.

In an Order entered on October 1, 2004, the Bankruptcy Court in Virginia granted a motion by RoomStore to reject the assignment of the lease between Rhodes and NAP effective as of July 31, 2004. In August 2004, Rhodes and Roomstore entered into a contract called “Agreement to Modify Assignment.” The effect of RoomStore’s rejection of the assignment was that it had no further personal liability on the lease agreement with NAP, which counsel for NAP conceded at the oral argument. The Modification Agreement provided that RoomStore would continue to occupy the leased premises and would pay directly to Rhodes \$25,000 per month through November 30, 2008.

NAP wrote a letter to Rhodes dated October 26, 2004 demanding payment of \$42,590.47 for rent for the month of October 2004.

On November 4, 2004, Rhodes filed its bankruptcy petition initiating this case under Chapter 11. Later in November, RoomStore paid \$50,000 to NAP. In their stipulation of facts, the parties stated:

10. After the filing of Rhodes' bankruptcy case on November 4, 2004, RoomStore and NAP reached an agreement whereby RoomStore would thereafter make certain payments of rent owed to Rhodes under the Modification Agreement to NAP. Rhodes was unaware of this communication between NAP and RoomStore.

In December 2004 and in January 2005, RoomStore made two additional payments to NAP of \$25,000 each. NAP concedes that some of the \$100,000 must be applied to postpetition rent owed by Rhodes to it. There is no evidence that Rhodes authorized or approved the payments made by RoomStore to NAP.

Rhodes paid NAP rent of \$42,590.47 for the months of December 2004 through March 2005.

NAP contends that Rhodes still owes it postpetition rent for the months of April and May 2005. Rhodes concedes that it owes NAP approximately \$10,000, but it asserts that payment of the balance it concedes is due plus the postpetition payments it made to NAP plus the payments totaling \$100,000 made by RoomStore satisfy the base rent portion of what is due NAP postpetition through May 31.

NAP has the burden of proving that it is owed a postpetition expense. The stipulation of facts shows that the lease existed and had not been rejected prior to May 31. There is no dispute about the amount of monthly base rent. NAP acknowledges the four payments made directly by Rhodes and acknowledges that a portion of the payments made by RoomStore are properly

applied to postpetition debt. There may be some dispute about the amount of postpetition November rent (whether it is a prorated portion of the base rent or some lesser amount), and if so that issue is reserved because the parties have not addressed it. Also reserved are issues as to obligations other than rent that arose postpetition.

Rhodes contends that it is entitled to credit for all of the payments totaling \$100,000 that RoomStore made to NAP because the rent payments made by RoomStore to NAP were "proceeds" of the Modification Agreement and hence property of the estate. It reasons that NAP violated the automatic stay by exercising dominion over that estate property and hence that any act to apply estate property to prepetition debt was void as a violation of the automatic stay. This argument fails because the rent payments were not proceeds of the Modification Agreement in the sense of being something received in replacement of collateral and were not property of the estate.

The payments were made by check. NAP's bank credited its account when RoomStore's checks cleared, and RoomStore's bank debited its account. Rhodes had no interest whatsoever in RoomStore's claim against its bank before the checks cleared or in NAP's claim against its bank after the checks cleared. NAP and RoomStore agreed that RoomStore would make to NAP "payments of rent owed to Rhodes," but the labels put on the payments made by RoomStore do not determine whether they were in fact property of the estate.

NAP's argument that it had a legal right to apply RoomStore's payments to its prepetition claim against Rhodes has two main parts. First, it contends that RoomStore had the right to "protect itself" by curing Rhodes' default pursuant to paragraph 4 of the Modification Agreement, which provides:

4. Default. Any act or omission by Rhodes or RoomStore, which would be deemed an event of default under the lease, shall be a material breach of this Agreement and shall be deemed an 'Event of Default.' In the Event of Default by either party, the non-defaulting party shall have the right, but not the obligation, in addition to all of its other remedies at law or equity, to cure such default and charge the defaulting party therefore. The defaulting party shall reimburse the non-defaulting party for any expenditure incurred with interest at a rate of eighteen percent (18%) per annum, or at such rate as is provided in the Lease, whichever is greater.

Protecting itself is what NAP asserts that RoomStore did.

Second, NAP contends that although it had no contractual relationship with RoomStore, they had a legal relationship created by paragraph 5 of the Modification Agreement, which provides:

5. Remainder of Lease Unchanged. Except as modified by this Agreement, the remaining provisions of the Lease remain unchanged and RoomStore shall comply with all the terms and conditions of the Lease and shall perform all of the obligations of the Lease. If the Lease terminates, this Agreement shall terminate and the parties shall be relieved from all further liabilities and obligations under this Agreement. Should there be any conflict between the terms of this Agreement and the terms of the Lease, which are incorporated herein by reference, the terms specifically set out herein shall control.

NAP points out that RoomStore's rejection of the Assignment Agreement did not terminate that contract as a matter of state law. Hence, Rhodes could enforce RoomStore's promise in the Modification Agreement to perform obligations under the lease and to pay rent to Rhodes. The Assignment Agreement declared NAP to be a third-party beneficiary of that agreement between Rhodes and RoomStore. NAP asserts that Rhodes and RoomStore agreed in the Modification Agreement that NAP was a third-party beneficiary of the promises made there. As a third-party beneficiary, it claims that it had the right to accept the payments made by RoomStore and to apply them to prepetition rent because it could enforce RoomStore's promise to Rhodes to pay

rent and Rhodes had empowered RoomStore to protect its possessory interest in the premises by curing monetary defaults.

NAP's argument might have some validity outside of a bankruptcy context, but, inside bankruptcy, it clashes with the fundamental principle that similarly situated unsecured claims must be treated alike. See 11 U.S.C. §§ 1129(a)(7) and 726. The net effect of NAP's application of the payments to October rent, if permitted, would be to reduce the net worth of the estate by the amount of rent paid to NAP and to reduce prepetition debt owed by Rhodes by the same amount. It does not take Kurt Gödel to prove that this would be an unfavorable result for other unsecured creditors. When the transaction is collapsed, it is as if Rhodes took estate property and paid NAP's prepetition claim. In the absence of a benefit to the estate (which NAP did not prove), the Court could not have authorized Rhodes to make such a payment. Hence, to accept NAP's arguments would be to accept the proposition that it could do indirectly what Rhodes was forbidden to do directly.

The first part of NAP's argument begs the question of whether RoomStore's checks paid prepetition rent in part or paid only postpetition rent. NAP suggests that because the Modification Agreement provided that RoomStore had an option to cure a default, that is what it should be deemed to have done for the purpose of "protecting itself."

This argument flounders on a lack of proof that the payments were in fact were provided to cure the default. NAP presented no evidence to show that RoomStore's purpose was to cure the prepetition default. The only evidence on this point, based on RoomStore's intention, is to the contrary. Recall that the rent payments were made after Rhodes filed bankruptcy and that RoomStore had no personal, direct liability to pay rent to NAP. Curing the default might have made sense if RoomStore intended to induce Rhodes to assume the lease and assign it to

RoomStore. But RoomStore had rejected the prior Assignment Agreement just a few months earlier. There is no evidence that Roomstore had decided to reverse its previous decision to be free of liability under the lease.

Paying the October rent did not provide RoomStore with any short-term benefit that it did not already enjoy. NAP could not regain the premises until Rhodes rejected the lease so long as Rhodes paid postpetition rent. Hence, it was in RoomStore's interest, to the extent it wished to continue to use the premises in the short term, to assist Rhodes in paying postpetition rent.

Paying the prepetition rent would not have prolonged, and did not prolong, the period during which RoomStore could use the leased premises beyond the period beginning on November 4, 2004 and ending on the date of rejection by Rhodes.

Central to NAP's argument, which its counsel voiced at oral argument, is the notion that RoomStore could cure Rhodes' defaults "to protect itself." Assuming for the sake of argument that RoomStore could have paid October rent in order to "protect" itself, there is no evidence it made the payment for that purpose or had any need for such protection beyond that afforded indirectly by the automatic stay in Rhodes' bankruptcy case. Thus, RoomStore had no rational basis for curing the prepetition default of Rhodes.

RoomStore did have a powerful incentive, however, not to agree to the allocation of its payments to the prepetition debt. Though Roomstore had an option under the Modification Agreement prior to Rhodes' bankruptcy to "cure such default and charge the non-defaulting party therefore," it had no right after Rhodes filed bankruptcy to charge Rhodes for rent payments not credited to Rhodes' postpetition obligations to NAP.

First, RoomStore had a prepetition claim against Rhodes for breaching its obligation in the Modification Agreement to pay October rent. Any act to collect that prepetition debt,

however, would have violated section 362(a)(6) of the Bankruptcy Code. The Court presumes that RoomStore, itself a Chapter 11 debtor, was not about the business of blatantly violating the automatic stay in Rhodes' case, and there is no evidence it did. NAP is presumed to know the law and hence is charged with the knowledge of the constraints on RoomStore, one of which was that it could not use its own assets to cure a default without being able to make a "charge" against Rhodes. There is no evidence that the Bankruptcy Court in RoomStore's case authorized it to pay rent twice. It follows that in the absence of any evidence of reckless conduct by RoomStore, the payments made by RoomStore to NAP were in respect to postpetition rent owed by Rhodes.

Second, RoomStore could not have succeeded in arguing that a charge against Rhodes under paragraph 4 of the Modification Agreement should be treated as an administrative expense. Section 503(b)(1) governs allowance of administrative expenses, which are the "actual, necessary costs and expenses of preserving the estate." Paying an obligation in full that Rhodes was not obliged to pay preserved no value for the estate at all.

Third, it is the trustee's duty (here the duty of the debtor in possession) under section 365 of the Bankruptcy Code to determine whether to assume an executory contract or unexpired lease, which would require curing any default. The NAP lease, the Assignment Agreement and Modification Agreement are all subject to the provisions of section 365 in this case. RoomStore was barred from curing the prepetition default under the lease because otherwise it would have usurped the powers of a trustee.

In effect, NAP is arguing that RoomStore paid a debt that it did not owe and as to which it would have had no right to reimbursement or credit from Rhodes with respect to a lease that neither it nor Rhodes had assumed or expressed any intention of assuming. It did so, NAP says,

to protect an interest in using the leased premises that the automatic stay in Rhodes' bankruptcy case already fully protected, which protection was not in the least enhanced by reason of payment of October rent. The argument is absurd.

NAP's contention that it is a third-party beneficiary also negates the proposition that the payments made by RoomStore were to pay October rent. The choice of law provision in the Modification Agreement refers to Virginia law, which applies to the question of whether the parties intended NAP to be a third-party beneficiary.

In order to proceed on the third-party beneficiary contract theory, the party claiming the benefit must show that the parties to a contract "clearly and definitely intended" to confer a benefit upon him. Thus, *Code 55-22* has no application unless the party against whom liability is asserted has assumed an obligation for the benefit of a third party. Put another way, a person who benefits only incidentally from a contract between others cannot sue thereon.

Copenhaver v. Rogers, 238 Va. 361, 367, 384 S.E.2d 593, 596 (Va. 1989) (citations omitted).

See also MNC Credit Corp. v. Sickels, 255 Va. 314, 497 S.E.2d 331 (Va. 1998).

NAP offered no evidence to show that in entering into the Modification Agreement, RoomStore assumed an obligation for NAP's benefit. In view of the rejection of the Assignment Agreement, which eliminated any liability of RoomStore to NAP, the redirection of rent payments from NAP to Rhodes and the omission of any third-party beneficiary language in the Modification Agreement, it is arguable that Rhodes and RoomStore did not intend NAP to be a third-party beneficiary.

Nonetheless, assume for the sake of the argument that NAP was a third-party beneficiary of RoomStore's promise to pay rent to Rhodes. As a third-party beneficiary, NAP could have enforced, and accepted performance of, RoomStore's unfulfilled promise to pay rent of \$25,000 per month to Rhodes (in a non-bankruptcy context). When a promisor pays a third-party

beneficiary of the promise, the promisor's obligation to the promisee is satisfied. The Restatement (Second) of Judgments and the Restatement (Second) of Contracts make this point clear. Otherwise, contracting parties would go to great lengths to disavow any intention of creating a donee or creditor beneficiary to avoid having to pay twice.

§ 56(3) of the Restatement (Second) of Judgments states:

When a contract between two persons creates an obligation in favor of another person as an intended beneficiary:

...

(3) The promisor's satisfaction of a judgment in favor of the beneficiary or of a judgment in favor of the promisee satisfies the obligation to the other of them in accordance with the rules in §§ 305 and 310 of the Restatement, Second, of Contracts.

§ 305 of the Restatement (Second) of Contracts states:

(1) A promise in a contract creates a duty in the promisor to the promisee to perform the promise even though he also has a similar duty to an intended beneficiary.

(2) Whole or partial satisfaction of the promisor's duty to the beneficiary satisfies to that extent the promisor's duty to the promisee.

§ 310(1) of the Restatement (Second) of Contracts states:

(1) Where an intended beneficiary has an enforceable claim against the promisee, he can obtain a judgment or judgments against either the promisee or the promisor or both based on their respective duties to him. Satisfaction in whole or in part of either of these duties, or of a judgment thereon, satisfies to that extent the other duty or judgment, subject to the promisee's right of subrogation.

Thus, NAP's theory that it is a third-party beneficiary dovetails with its acknowledgment that RoomStore was paying to NAP the rent that RoomStore owed to Rhodes. The payments to NAP had to extinguish RoomStore's obligation to pay rent to Rhodes. But here is the rub: the extinguishment of Rhodes' claim against RoomStore constituted an "act . . . to exercise control

over property of the estate” in violation of section 362(a)(3) of the Bankruptcy Code and was therefore prohibited. *See In re Granite Properties, L.P.*, 194 B.R. 318, 333 (Bankr. S.D.N.Y. 1996) (“[T]he assertion of the third party beneficiary claims ordinarily violates the automatic stay.”) Furthermore, in applying the payments made by RoomStore to its prepetition claim against Rhodes, NAP violated section 362(a)(6) of the Bankruptcy Code, which enjoins any act to “collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.”

NAP tries to tiptoe around the automatic stay by asserting that it did not demand payment from RoomStore or otherwise induce it to make the payments and that RoomStore did not direct how the payments were to have been applied. These facts, if true, are irrelevant and would not insulate NAP from the injunction imposed by section 362(a). By asserting that it is a third-party beneficiary of the Modification Agreement and that the funds provided to it by RoomStore was payment of rent owed to Rhodes, NAP necessarily concedes that the payment by RoomStore to NAP would extinguish Rhodes’ claim against RoomStore. Consequently, it cannot wiggle out of the fact that it is admitting that it engaged in an act to exercise control over estate property, which could not have occurred but for its willingness to accept the funds.

NAP failed to satisfy its burden of proof that Rhodes is indebted to it for postpetition rent, the reserved issues aside. Any act it committed in furtherance of its quest to apply the postpetition payments made by RoomStore to its prepetition claim against Rhodes violated the automatic stay and is void. Accordingly, it is

ORDERED that the motion of NAP Chesterfield, L.P. to Compel Debtor to Pay Rent Under an Unexpired Lease of Nonresidential Real Property (Document No. 691) is **DENIED**

with respect to rent alleged to be due based on application of funds received from HMY
RoomStore, Inc. to its prepetition claim for base rent against Debtor.

Dated: June 28, 2005.



JAMES E. MASSEY
U.S. BANKRUPTCY JUDGE