NY Bankruptcy Court Pivots On Commercial Rent Damage Cap

By **Mark Edelstein, Theresa Foudy and Martha Martir** (April 28, 2023)

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Departing from prior precedent, a recent opinion by the U.S. Bankruptcy Court for the Southern District of New York in In Re: Cortlandt Liquidating LLC[1] effectively lowered the Bankruptcy Code Section 502(b)(6) cap on rejection damages that a commercial real estate landlord may claim by holding that the cap should be calculated using the time approach rather than the rent approach.

By doing so, U.S. Bankruptcy Judge Michael E. Wiles made the court a little less landlord friendly, though it remains to be seen whether other bankruptcy judges will follow his lead. If they do, prospective Chapter 11 debtors looking to right-size their footprint may now find the bankruptcy court a more attractive venue.

Calculation of Rejection Damages for Commercial Leases

When a debtor tenant rejects a real property lease of nonresidential real property, e.g., a commercial ground lease or space lease, Section 502(b)(6) of the Bankruptcy Code provides for a statutory cap on the amount of a landlord's unsecured rejection damages claim in an amount equal to:

> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
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> > (i) the date of the filing of the petition; and
> >
> > (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
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> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.[2]

This damage cap is, in essence, a social policy enacted by Congress to prevent commercial lease rejection damage claims[3] from dwarfing all other unsecured claims,[4] and has been codified in the Bankruptcy Code since 1934.[5]

Courts are divided on how to interpret "15 percent, not to exceed three years, of the remaining term of such lease" in Section 502(b)(6)(A) between the time approach versus the rent approach.

Time Approach

Under the time approach, which has been adopted by a majority of the courts to address the issue, lease rejection damages are capped at the rent that is specified for the first 15% of the remaining lease term, as long as that time period is at least one year and no more than three years.

Rent Approach

The rent approach has been adopted by a minority of the courts to address the issue, including the SDNY.

Under this approach, lease rejection damages are capped at 15% of the total dollar amount of the rent that would be payable for the entire remaining term of the lease, as long as that amount is at least equal to the rent reserved for the next one year and does not exceed the rent reserved for the next three years of the lease term.

Because rents under a commercial real estate lease generally escalate over time, the rent approach typically results in a higher rejection damages amount — sometimes significantly so.

This is because the time approach ignores rent escalations that occur after the first 15% of the remaining lease term, whereas the rent approach captures any rent escalations occurring during the entire duration of the lease. In doing so, the rent approach usually results in a higher cap amount.

Split in Authority Between the Rent Approach and Time Approach

As noted by Judge Wiles in Cortlandt, each position finds support in modern case law.

On the one hand, courts in districts in Alaska, California, Colorado, Delaware, Florida, North Carolina and Pennsylvania have applied the time approach.[6] On the other hand, courts in districts in Florida, Illinois, Michigan, New York and North Dakota have adopted the rent approach.[7] None of the circuit courts of appeals have ruled on the issue.

Generally, courts adopting the time approach have found that damages should be measured according to the total amount of time remaining under the lease because the statute references time periods.[8]

In addition, such courts have reasoned that Congress' intent in limiting a commercial landlord's rejection damages claims was to recognize that the landlord was receiving its property back for the remaining term of the lease and would have the opportunity to re-let the premises for that period of time.[9]

In contrast, courts adopting the rent approach have reasoned that permitting landlords to collect damages based on 15% of the aggregate rent still owed under the lease "will more accurately compensate them for their loss while the 15 percent limitation on the rent recoverable will concomitantly ensure that other general creditors will have an opportunity to recover from the estate."[10]

These courts have also found that, while the statute is not a "model of clarity," the rent approach is the more "natural" reading of the statutory language.[11]

The SDNY Bankruptcy Court Adopts Time Approach

Against this backdrop, Judge Wiles has now departed from prior SDNY precedent to adopt the time approach.

In doing so, he noted that, in the 10-year period since the last SDNY bankruptcy case to adopt the rent approach, the vast majority of the reported opinions and other precedent

had adopted the time approach.

Judge Wiles found the latter cases and authority to be more consistent with both the plain language of the statute and the legislative history.

Plain Language

Judge Wiles found that the plain language of the statute makes clear that the time approach is the correct method of calculation.

Judge Wiles noted that the "entire phrase is worded in terms of periods of time," and that the words "'one year' and 'three years' modify the words 'of the remaining term of such lease.'"[12]

Legislative History

Judge Wiles also found that the legislative history supports the time approach, because the provisions of the Bankruptcy Act, i.e., the law in effect prior to the current Bankruptcy Code, were time based, and the legislative history does not clearly indicate that Congress intended to deviate from that time-based approach in enacting the Bankruptcy Code.

Equity and Fairness

Further, Judge Wiles found that considerations of equity and fairness do not favor one approach over the other and cautioned against substituting one's own views of equity and fairness in place of a statute's plain language.

Key Takeaways Moving Forward

While it remains to be seen if other SDNY bankruptcy judges will follow Judge Wiles in adopting the time approach, the Cortlandt decision calls into doubt whether landlords will be able to take advantage of the rent approach when asserting future rejection damages claims in the SDNY.

Until Congress clarifies the meaning of Section 502(b)(6)(A), or the U.S. Court of Appeals for the Second Circuit weighs in, there will be uncertainty as to the proper method for calculating landlord rejection damages claims in the SDNY.

Nonetheless, should other SDNY bankruptcy judges follow Judge Wiles' lead, the SDNY could start looking like a more attractive venue for prospective debtors planning to reject significant commercial leases.

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[1] 648 B.R. 137 (Bankr. S.D.N.Y. 2023).

[2] 11 U.S.C. § 502(b)(6).

[3] Notably, a landlord is also entitled to a claim for any unpaid prepetition rent in addition to the capped amount for rejection damages. In addition, a landlord has an administrative claim under section 365(d)(3) of the Bankruptcy Code for rent and charges incurred from the petition date through the date that the debtor assumes or rejects the lease.

[4] The "cap" excludes secured claims, such as pledged cash security deposits and letters of credit.

[5] See In re Connectix Corp., 372 B.R. 488, 491–92 (Bankr. N.D. Cal. 2007) (citing Oldden v. Tonto Realty Corp., 143 F.2d 916, 918 (2d Cir. 1944)).

[6] See, e.g., Sunbeam-Oster Co. v. Lincoln Liberty Ave. Inc. (In re Allegheny Int'l, Inc.), 145 B.R. 823 (W.D. Pa. 1992); In re Keane, No. 19-05635-5-DMW, 2020 Bankr. LEXIS 2900 (Bankr. E.D.N.C. Oct. 14, 2020); In re Filene's Basement, LLC, No. 11-13511 (KJC), 2015 Bankr. LEXIS 1350 (Bankr. D. Del. Apr. 16, 2015); In re Denali Family Servs., 506 B.R. 73 (Bankr. D. Alaska 2014); In re Shane Co., 464 B.R. 32 (Bankr. D. Colo. 2012); In re Connectix Corp., 372 B.R. 488 (Bankr. N.D. Cal. 2007); In re Ace Elec. Acquisition, LLC, 342 B.R. 831 (Bankr. M.D. Fla. 2005).

[7] See, e.g., In re Rock & Republic Enters., No. 10-11728, 2011 Bankr. LEXIS 2401 (Bankr. S.D.N.Y. June 20, 2011); In re Andover Togs, Inc., 231 B.R. 521, 547 (Bankr. S.D.N.Y. 1999); In re Today's Woman of Florida, Inc., 195 B.R. 506 (Bankr. M.D. Fla. 1996); In re Gantos, Inc., 176 B.R. 793 (Bankr. W.D. Mich. 1995); In re Fin. News Network, Inc., 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993); In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 232 (Bankr. D.N.D. 1992); Schwartz v. C.M.C., Inc. (In re Communicall Cent., Inc.), 106 B.R. 540 (Bankr. N.D. Ill. 1989).

[8] See Allegheny, 145 B.R. at 828.

[9] See id.

[10] Gantos, 176 B.R. at 795.

[11] Id. at 795; see also Communicall Cent., 106 B.R. at 543-44; Fin. News Network, 149 B.R. at 352.

[12] 648 B.R. at 141.