

Bankruptcy Ruling Shifts Lease Rejection Claim Calculation

By **Bethany Simmons and Noah Weingarten** (May 2, 2024)

In its March decision *In re: Cortlandt Liquidating LLC*,^[1] the U.S. District Court for the Southern District of New York provided guidance on how to properly calculate a landlord's damages claim when a bankruptcy debtor rejects a lease.

When a bankruptcy debtor rejects a lease, the landlord is entitled to a rejection damages claim. Under Section 502(b)(6) of the U.S. Bankruptcy Code, the landlord's claim is capped at "the rent reserved by such lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease."

Courts have taken two different approaches in interpreting what constitutes the 15% referenced in the statute.

The first approach, referred to as the rent approach, calculates the 15% based on the remaining rent due under the lease. The second approach, referred to as the time approach, calculates the 15% based on the remaining time under the lease.

The difference in these two approaches is irrelevant where the claim is based on the extreme ends of Section 502(b)(6) claims — i.e., where the claim is equal to the one-year rent minimum or equal to the three-year rent maximum. In other words, the difference in the rent vs. time approaches matters when the claim falls between both ends of the spectrum.

Bankruptcy courts in the Southern District of New York have historically followed the rent approach, but pursuant to the *Cortlandt* decision, are now directed to follow the time approach.

The Rent Approach

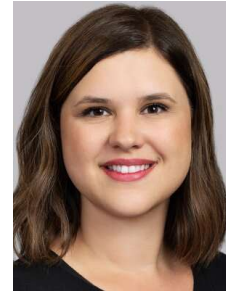
Under the rent approach, a landlord's claim is capped at the amount equal to 15% of the total dollar amount of rent that would be payable for the entire remaining term of the lease, so long as that dollar amount is at least equal to the rent due for one year and does not exceed the rent due for the next three years of the lease term.

Many long-term commercial leases provide for escalating amounts of rent due. The rent approach captures these rent escalations.

Consequently, the rent approach may lead to a higher claim amount and potentially higher recovery for a landlord.

The Time Approach

Under the time approach, the landlord's claim is capped at the rent that would be due during the time period equal to 15% of the remaining lease term, so long as that time period is at least one year and no more than three years.



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Unlike the rent approach, the time approach ignores rent escalations that would occur in later years of a lease. Thus, the time approach would result in a lower claim than the rent approach.

Bankruptcy Courts in the Southern District of New York and the Rent Approach

Since 1993, beginning in *In re: Financial News Networks Inc.*,^[2] the U.S. Bankruptcy Court for the Southern District of New York has followed the rent approach. The rent approach was affirmed in 1999 by the bankruptcy court *In re: Andover Togs Inc.*^[3]

In that case, the court found that the statutory language of Section 502(b)(6) was ambiguous, and the legislative history was "unilluminating."

Nevertheless, according to the *Andover Togs* court, the rent approach was the "logically sounder approach," was followed by the majority of courts at the time, and was endorsed by leading bankruptcy treatises.

In 2011, in *In re: Rock & Republic Enterprises Inc.*,^[4] the bankruptcy court again applied the rent approach, declining to depart from the precedent established by *Financial News Networks* and *Andover Togs*.

Southern District of New York Now Follows the Time Approach

The question of the proper interpretation of Section 502(b)(6) was again raised in the bankruptcy court last year in *In re: Cortlandt Liquidating LLC.*^[5]

This time, however, the bankruptcy court, with U.S. Bankruptcy Judge Michael Wiles presiding, departed from prior precedent in the district and held that the time approach — not the rent approach — is the correct interpretation of the statute.

The bankruptcy court began by noting that, in the more than 10 years since the *In re: Rock & Republic Enterprises* case, the weight of authorities has shifted strongly in favor of the time approach, with all reported decisions since 2012 following the time approach and with several leading treatises now endorsing it as well.

The bankruptcy court also engaged in a textual analysis to support its application of the time approach. It observed that Section 502(b)(6) is worded entirely in terms of periods of time in that it refers to the rent reserved under lease, without acceleration "for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease."

The court found that if

Section 502(b)(6) were intended to impose a cap that is based on 15% of a dollar amount ... then the words "15 percent" would not have been sandwiched between two other time periods, and they would not have been used as a modifier of the phrase "of the remaining term of such lease."

In other words, the words "15 percent" were placed between the time frame of "one year" and "three years" of rent due under a lease.

The bankruptcy court also noted that the time approach is supported by legislative history. As the bankruptcy court explained, beginning in 1938, landlords could assert a claim for rent for the next three years following surrender of a lease.

The percentage calculation was introduced in the 1978 draft of the Bankruptcy Code with no indication that Congress intended to move away from calculating the landlord's damages cap based on the time period following lease rejection.

The bankruptcy court then addressed, and dismissed, arguments that considerations of equity and fairness favor the rent approach over the time approach, finding that the "intent" of the statute was to limit landlord claims.

However, that general intent alone provides no instruction regarding whether Congress intended for the rent approach or time approach to be used. Instead, according to the bankruptcy court, what is fair and equitable likely depends on a party's point of view, with landlords preferring an interpretation that results in a higher cap and other creditors preferring an interpretation that results in a lower cap.

While the landlord in Cortlandt appealed, the U.S. District Court for the Southern District of New York affirmed the bankruptcy court's decision in an opinion on March 26.[6]

The district court agreed with the bankruptcy court's assessment that the plain language of the statute supports the time approach, and it is consistent with legislative history and the emerging consensus of authorities.

Takeaway

The district court's affirmance of the Cortlandt decision is the first district court decision in the Second Circuit on this point.

It represents a departure from the prior established precedent and shifts how landlord lease rejection claims will need to be calculated in the Southern District of New York moving forward.

The Cortlandt decision also narrows the split among courts regarding whether the time approach or rent approach is the correct interpretation of the statute, with the majority now following the time approach. Nevertheless, certain courts still follow the rent approach.

Parties should continue to research the approach applicable in the district where a given bankruptcy case is pending for guidance on how to calculate a landlord's Section 502(b)(6) claim.

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[1] Lincoln Triangle Commer. Holding Co. LLC v. Halperin (In re Cortlandt Liquidating LLC), No. 1:23-cv-03262-MKV, 2024 U.S. Dist. LEXIS 56989 (S.D.N.Y. Mar. 26, 2024).

[2] In re Financial News Networks Inc., 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993).

[3] In re Andover Togs Inc., 231 B.R. 521, 547 (Bankr S.D.N.Y. 1999).

[4] In re Rock & Republic Enters., No. 10-11728 (AJG), 2011 Bankr. LEXIS 2401 (Bankr. S.D.N.Y. June 20, 2011).

[5] In re Cortlandt Liquidating, 648 B.R. 137 (Bankr. S.D.N.Y. 2023).

[6] In re Cortlandt Liquidating LLC, 2024 U.S. Dist. LEXIS 56989, at *21.