Landlords Beware: Bankruptcy Court for Southern District of New York Reverses Course on Calculation of Lease Rejection Damages in Bankruptcy

*By Benjamin Mintz and Justin Imperato**

In this article, the authors discuss a recent decision by a federal bankruptcy judge in New York regarding the damages a landlord is entitled to recover in a tenant's bankruptcy case where the tenant rejects its lease.

Bankruptcy Judge Michael Wiles recently issued an opinion in *In re Cortlandt Liquidating LLC*[1] that negatively impacts the damages a landlord is entitled to recover in a tenant's bankruptcy case should the tenant elect to reject its lease.

BACKGROUND

In the event a debtor-tenant rejects a real property lease, Bankruptcy Code Section 502(b)(6) caps the amount of the landlord's 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—

(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

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.[2]

In *Cortlandt Liquidating*, Judge Wiles interpreted the above language in Section 502(b)(6) and his interpretation departs from more than two decades of precedent in the Bankruptcy Court for the Southern District of New York.

TWO APPROACHES

Courts have espoused one of two interpretations for Section 502(b)(6).

Some courts have adopted the "Time Approach." Under this approach, a landlord's allowed claim for lease rejection damages is capped at the rent that is reserved under the relevant lease for a specified time period, and

*The authors, attorneys based in the New York office of Arnold & Porter Kaye Scholer LLP, may be contacted at benjamin.mintz@arnoldporter.com and justin.imperato@arnoldporter.com, respectively.

that time period is equal to the first 15 percent of the remaining lease term, so long as that time period is at least one year and no more than three years.[3]

Other courts have adopted the "Rent Approach."

Under the Rent Approach, a landlord's allowed claim for lease rejection damages is capped at 15 percent of the total dollar amount of the 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 reserved for one year's rent and does not exceed the rent reserved for the next three years of the lease term.[4]

In many instances, the Time Approach and the Rent Approach will yield significantly different outcomes to the detriment of the landlord whose lease has been rejected and is entitled to assert a damage claim against the debtor-tenant under Section 502(b)(6). Rents under a lease often escalate over time. The Time Approach imposes a cap that is based on the rents that are specified for the first 15 percent of the remaining lease term; it thereby ignores rent escalations that would occur in later years. The Rent Approach, by contrast, imposes a cap that is based on 15 percent of all of the rents that are specified for the entire remaining lease term. The Rent Approach thereby captures an element of rent escalations that the Time Approach does not capture, and in doing so, it results in a higher cap amount.

EXAMPLE

The resulting differences from application of the Time Approach versus the Rent Approach are best illustrated by example: assume a lease with a remaining term of 10 years and the following annual rent:

(i) Remaining years 1–3, $200,000 ($600,000 total),

(ii) Remaining years 4–6, $300,000 ($900,000 total), and

(iii) Remaining years 7–10, $400,000 ($1,600,000 total), for a grand total of $3,100,000 for the entire remaining 10 years.

Under the Time Approach, the lease rejection damage cap would be $300,000, calculated as the rent coming due over the next 15 percent of the remaining term (1.5 years), not to exceed the next three years of rent ($600,000).

Under the Rent Approach, the lease rejection damage cap would be $465,000, calculated as 15 percent of $3,100,000, not to exceed the next three years of rent ($600,000).

THE DECISION

Since at least 1993, judges in the Bankruptcy Court for the Southern District of New York have utilized the more landlord-friendly Rent Approach in calculating lease rejection damages.[5] After considering the language of the statute and case law in other districts, including more recent authority adopting the Time Approach, Judge Wiles, however, concluded that the Time Approach is the correct method of calculating lease rejection damages. He observed that:

> [i]f section 502(b)(6) were intended to impose a cap that is based on 15% of a dollar amount (as the proponents of the Rent Approach suggest), 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.' Instead, if the Rent Approach had been intended, the statute would have stated that the allowable rejection damages would not exceed '15 percent of the rent reserved for the remaining term of such lease, provided that such amount will not be less than the rent reserved for the next year of the lease term, and shall not be more than the rent reserved for the next three years of the lease term.'[6]

CONCLUSION

Judge Wiles acknowledged the *Cortlandt Liquidating* decision was a departure from prior precedent within the district.[7] It remains to be seen whether other judges in the district will pivot to the Time Approach or continue to adhere to the Rent Approach.

NOTES:

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

[2]11 U.S.C. § 502(b)(6).

[3]See, e.g., In re Keane, 2020 WL 6122296, *2 (Bankr. E.D.N.C. 2020); In re Denali Family Services, 506 B.R. 73, 83 (Bankr. D. Alaska 2014); In re Filene's Basement, LLC, 2015 WL 1806347, *6 (Bankr. D. Del. 2015); In re Shane Co., 464 B.R. 32, 39 (Bankr. D. Colo. 2012).

[4]See, e.g., In re Andover Togs, Inc., 231 B.R. 521 (Bankr. S.D.N.Y. 1999); In re Gantos, Inc., 176 B.R. 793, (Bankr. W.D. Mich. 1995); In re Communicall Cent., Inc., 106 B.R. 540 (Bankr. N.D. Ill. 1989).

[5]See In re Rock & Republic Enterprises, Inc., 2011 WL 2471000 (Bankr. S.D.N.Y. 2011); In re Andover Togs, Inc., 231 B.R. 521, 547 (Bankr. S.D.N.Y. 1999); In re Financial News Network, Inc., 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993).

[6]See In re Cortlandt Liquidating LLC, 648 B.R. 137, 142 (Bankr. S.D.N.Y. 2023).

[7]See id. at *7 ("I do not lightly depart from prior precedent in this District. After considering the statutory language and the relevant authorities, however, I am convinced that the Time Approach represents the correct view.").