

Southern District of New York Rules That “Time” Approach Applies to Calculating Landlord’s Lease Termination Claim in Bankruptcy Cases

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In this article, the authors examine a recent federal court decision explaining how to calculate the “statutory cap” on damages a landlord can claim arising from the termination of a lease in a bankruptcy case.

Bankruptcy Code Section 502(b)(6) establishes a “Statutory Cap” on the damages a landlord can claim arising from the termination of a lease in a bankruptcy case. Courts have split on how to calculate the Statutory Cap, whether and how to apply letters of credit to reduce the Statutory Cap, and whether the Statutory Cap applies to a landlord’s claims against a lessee’s debtor-guarantor.

The U.S. District Court for the Southern District of New York recently issued an opinion¹ addressing the foregoing issues:

(a) In a break with established bankruptcy court rulings in the Southern District of New York, the district court applied the “time” approach rather than the “rent” approach when calculating a lessor’s claim for rent arising from the termination of a lease in a bankruptcy case under the Statutory Cap set forth in 11 U.S.C.A. § 502(b)(6);

(b) The district court clarified what conduct constitutes a “termination” that triggers the application of the Statutory Cap;

(c) In the absence of any decisions on point by the U.S. Court of Appeals for the Second Circuit, the district court held that the Statutory Cap applies to claims against a debtor-guarantor that was not the tenant;

(d) The district court held that proceeds of a letter of credit drawn by the landlord should be applied to reduce the amount a debtor owed under the Statutory Cap, but only where the debtor funded the letter of credit with its assets; and

(e) The district court held that the lessor’s store cleanup costs were subject to the Statutory Cap because they arose from the termination of the parties’ lease.

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LIMITS ON A LANDLORD'S CLAIM FOR DAMAGES

In a bankruptcy case, the debtor has the ability to “reject” a lease of real property, which allows the debtor to escape from burdensome leases. A rejection is treated as a material breach by the debtor excusing the landlord’s future performance, but it does not by itself constitute a technical termination of the lease. Following the rejection of a lease, the lessor is entitled to file a claim against the bankruptcy estate to recover damages arising from such rejection. In contrast, if a debtor “assumes” a lease of real property, the debtor must cure all outstanding defaults and remains bound by the lease as if the bankruptcy case never occurred.²

However, Section 502(b)(6) establishes the Statutory for a landlord’s damages following rejection and termination of the lease. Under Section 502(b)(6) of the Bankruptcy Code,

“the court . . . shall determine the amount of such claim . . . and shall allow such claim in such amount, except to the extent that . . . if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property,” such claim exceeds “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.”³

The Statutory Cap compensates a landlord for damages while preventing a lessor’s claim for rent and related charges resulting from the termination of its lease following rejection - which often can total tens of millions of dollars - from overwhelming the other unsecured claims of the bankruptcy estate.⁴

As set forth below, the Cortlandt Case posed unusual facts. Unlike the typical scenario where the lessee and guarantor both file for

bankruptcy, (a) the lessee terminated the lease but did not file for bankruptcy; (b) the guarantor of the lease did file for bankruptcy; and (c) the district court applied the Statutory Cap in connection with the claim filed by the lessor under the guaranty against the debtor-guarantor.

COURTS ARE DIVIDED ON HOW TO CALCULATE THE STATUTORY CAP: THE “TIME” VERSUS “RENT” APPROACH

Courts have taken one of two approaches to calculating the amount of the Statutory Cap. These approaches arise from differing interpretation of the phrase “the greater of one year, of 15 percent, not to exceed three years, of the remaining term of such lease.” The key distinction turns on whether the 15 percent cap refers to a period of time under a lease (time approach) or to the dollar amount of rent remaining under the applicable lease (rent approach).

According to the time approach, the lessor’s damages claim is capped at the amount of rent due for the first 15 percent of the remaining term of the lease, up to three years. The time approach therefore excludes any rent escalations arising during the remaining term of the lease. So, for a lease with 10 years remaining in its term, the lessor’s damages would be capped at the amount of rent coming due for the next 1.5 years (15 percent of the remaining lease term).

Under the rent approach, the Statutory Cap limits a lessor’s damages to 15 percent of the total remaining rent to be paid for the balance of the lease term, up to an amount equal to three years’ rent. The rent approach benefits lessors to the extent it captures rent increases

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in the lease that fall outside the time period applied in the time approach.

BACKGROUND OF THE CORTLANDT CASE

Lincoln Triangle Commercial Holding Co. LLC, as lessor, and C21 1972 Broadway LLC, as lessee, entered into a lease agreement for non-residential real property located at 1972 Broadway, New York, New York. The debtor-guarantor, Century 21 Department Stores LLC guaranteed the payment, performance, and observance of all of the lessee’s obligations under the lease (the guaranty). Additionally, the lessee’s obligations under the lease was secured by a letter of credit issued by JPMorgan Chase Bank, N.A., which was posted by the lessee, but funded by the debtor-guarantor.

On September 10, 2020, the debtor-guarantor and certain affiliates (collectively, the debtors), each commenced a voluntary case under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the Southern District of New York. Notably, the lessee did not file a petition for bankruptcy.

On October 9, 2020, but before the expiration of the lease, the lessee breached the lease by vacating the property, and by delivering the keys to lessor. The lessor disputed that these actions terminated the lease, drew down on the letter of credit, and held the proceeds as cash security. Thereafter, the lessor drew down on the cash proceeds on a monthly basis to cover rent and other lease obligations.

The lessor filed a proof of claim in the debtors’ chapter 11 cases under the guaranty asserting estimated damages of \$44,378,698.04, resulting from breach of the lease consisting of: (a) future rent amounts as provided in the

lease, (b) estimated amounts for future real estate taxes, operating expense escalations, utilities, and repairs, and (c) actual amounts for cleanup costs, mechanic’s liens that had been filed against the property, and costs to repair windows and other damage to the property.

The plan administrator for the debtor-guarantor’s bankruptcy case objected to the claim, arguing, *inter alia*, that: (i) the Statutory Cap limited the lessor’s damages under the guaranty; (ii) the lessor’s capped damages for lease termination should be calculated according to the time approach; (iii) the lessor’s additional damages for cleanup costs, mechanic’s liens, and other repairs could not be included in the Statutory Cap because they did not qualify as “rent reserved” under the statute; and (iv) the letter of credit should be deducted from the lessor’s claim under the Statutory Cap.

The bankruptcy court entered two separate orders with respect to the lessor’s claim, holding that:

1. The lease had been terminated for purposes of Section 502(b)(6);
2. The Statutory Cap is to be calculated using the time approach;
3. The letter of credit should be deducted from the lessor’s claim and reduce the amount under the Statutory Cap;
4. The cleanup costs sought by the lessor (if proved) would constitute damages arising from the termination of the lease for purposes of Section 502(b)(6) and therefore subject to the Statutory Cap; and

5. Claims for mechanic's liens, window repairs, and other repairs not resulting from termination of the lease (if proved) would not be subject to the Statutory Cap.

THE DISTRICT COURT BROKE WITH ESTABLISHED CASES IN THE SOUTHERN DISTRICT OF NEW YORK AND ADOPTED THE TIME APPROACH TO CALCULATING A LESSOR'S CLAIM AMOUNT UNDER THE STATUTORY CAP

Until the bankruptcy court decision in the Cortlandt Case, the "established cases in the Southern District of New York . . . all adopted the 'rent approach over the time approach.'" The district court broke from that precedent and instead endorsed the time approach over the rent approach. In so doing, the district court joined the majority of bankruptcy courts, as well as several Bankruptcy Code authorities, following the time approach. Indeed, as noted by the district court, all reported decisions since 2012 that have addressed this issue have endorsed the time approach.⁵

THE CAP APPLIES TO A CLAIM BY A LANDLORD AGAINST THE GUARANTOR OF A LEASE

The lessee in the Cortlandt Case was a non-debtor, and the only claim at issue was against the debtor-guarantor. Although the Second Circuit Court of Appeals had not yet ruled on the issue, the district court joined the majority of cases in holding that the Statutory Cap applies to claims by a landlord against its tenant's guarantor. The district court reasoned that (a) the statute's plain language "does not distinguish among types of debtors," and (b) the bankruptcy court's holding was consistent with the purpose of the Statutory Cap, which is to

allow the lessor compensation for its damages while preventing its claim from overwhelming the other general unsecured creditors of the bankruptcy estate.⁶

THE LESSEE'S INTENTIONAL ABANDONMENT OF THE PROPERTY TERMINATED THE LEASE FOR PURPOSES OF THE STATUTORY CAP

As noted above, the Statutory Cap applies to a lessor's claim for "damages resulting from the termination" of a lease. The Bankruptcy Code, however, does not define "termination" and there are few published opinions on the definition of "termination" in connection with the application of the Statutory Cap.

In the Cortlandt Case, after the lessee turned back the property to the lessor, the lessor refused to accept the lessee's termination of the lease. Instead, the lessor argued that its claim was not subject to the Statutory Cap, because the lease had not actually been "terminated." This is because, under New York state law, termination requires each of the lessor and lessee to view the lease as terminated. Therefore, the lessor argued that its refusal to accept turnover meant that the lease was never actually terminated under applicable state law, and accordingly, its claim should be allowed in full, rather than capped pursuant to the Statutory Cap.

The district court rejected the lessor's position, and it held that the lease became "functionally dead" (and therefore terminated for purposes of the Statutory Cap) when the lessee intentionally abandoned the property and returned the keys to the lessor. The court agreed that it would be an impermissible end run around the Bankruptcy Code if a lessor could avoid imposition of the Statutory Cap

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simply by refusing to recognize a lease’s termination after the lessee had intentionally abandoned the property.

PROCEEDS OF A LETTER OF CREDIT APPLY TO REDUCE THE CAPPED AMOUNT OF A LESSOR’S CLAIM

In addition to the time approach versus rent approach debate, bankruptcy courts have taken different views as to whether the amount allowed under the Statutory Cap should be reduced by the proceeds of a letter of credit posted in connection with the applicable lease.

The district court held that the proceeds of the letter of credit should be applied to reduce the claim owed under the Statutory Cap.⁷ According to the district court, the letter of credit should be so applied because the debtor-guarantor had funded the letter of credit.

THE DISTRICT COURT ADOPTS THE NINTH CIRCUIT’S TEST FOR DETERMINING WHETHER A LANDLORD’S DAMAGES CLAIMS RELATED TO LEASE TERMINATION ARE SUBJECT TO THE STATUTORY CAP

Last, courts are also split over whether additional claims are subject to the Statutory Cap, such as claims resulting from a lessee’s breach of its repair and maintenance obligations. The district court held that such claims that arose after the lessee’s termination of the lease were also subject to the Statutory Cap.

While there is no Second Circuit Court of Appeals decision on this issue, the district court adopted the Ninth Circuit Court of Appeals’ test⁸ described in *Saddleback Valley Cmty. Church v. El Toro Materials Co.* (*In re El*

Toro Materials Co.):⁹ “Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?”¹⁰ The district court answered this question in the negative, because under the lease, the lessee’s obligation to clean up the store “[u]pon expiration or other termination of this Lease.” At that point, the lease required the tenant to quit and surrender to landlord the premises, “vacant, broom clean, in good order and condition, ordinary wear and tear and damage for which tenant is not responsible under the terms of this lease excepted” Because the landlord would not have had a claim for cleanup costs, had the lessee assumed the lease, the district court found (a) any claim for cleanup costs only arose from the termination of the lease, and (b) therefore, such claims are “indeed subject to” the Statutory Cap.

NOTES:

¹*In re Cortlandt Liquidating LLC*, 2024 WL 1301429 (S.D. N.Y. 2024) (Cortlandt Case).

²11 U.S.C.A. § 365(a).

³11 U.S.C.A. § 502(b)(6).

⁴See H.R.Rep. No. 595, 95th Cong., 2d Sess. 63 (1978) S.Rep. No. 95-989, at 63 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5849 (explaining that the policy behind the Statutory Cap is to “compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate.”).

⁵*In re Cortlandt Liquidating LLC*, 648 B.R. 137, 141 (Bankr. S.D. N.Y. 2023), *aff’d*, 2024 WL 1301429 (S.D. N.Y. 2024).

⁶*In re Cortlandt Liquidating LLC*, 2024 WL 1301429, *4–5 (S.D. N.Y. 2024).

⁷*In re Cortlandt Liquidating LLC*, 2024 WL 1301429, *9 (S.D. N.Y. 2024).

⁸**Saddleback Valley Cmty. Church v. El Toro Materials Co.** (*In re El Toro Materials Co., Inc.*, 504 F.3d 978, 980–81, 48 Bankr. Ct. Dec. (CRR) 255, Bankr. L. Rep. (CCH) P 81021 (9th Cir. 2007).

⁹See e.g., *In re Rock & Republic Enterprises, Inc.*, 2011 WL 2471000, *25 (Bankr. S.D. N.Y. 2011).

¹⁰*In re Cortlandt Liquidating LLC*, 648 B.R. 137, 144 (Bankr. S.D. N.Y. 2023), *aff'd*, 2024 WL 1301429 (S.D.

N.Y. 2024); *In re El Toro Materials Co., Inc.*, 504 F.3d 978, 980–981, 48 Bankr. Ct. Dec. (CRR) 255, Bankr. L. Rep. (CCH) P 81021 (9th Cir. 2007).