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Escaping Burdensome Real Estate Leases in Bankruptcy: Relief for the Tenant? Grief for the Landlord?

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With an anticipated increase in brick-and-mortar retailer bankruptcies, landlords may find themselves with little control over the future of their leases with bankrupt retailers. The Bankruptcy Code was designed to provide a "fresh start" to debtors whose balance sheet was weighed down by too many obligations, too little income or insufficient cash flow. A debtor demonstrating a reasonable likelihood of a successful reorganization may be entitled to rid itself of costly real estate leases. But what are the rights of the landlord?

Subject to court approval, a debtor can assume (*i.e.*, continue to perform under the terms of the lease after it "cures" any arrears and provides "adequate assurance" of future performance) or reject unexpired leases. A debtor may also assume and assign a lease to another party.

If the debtor rejects a lease, the landlord may assert a claim consisting of (i) prepetition arrearages, (ii) capped "rejection damages", (iii) damages not "resulting from the termination of a lease" (such as claims for property damage and repair and maintenance), and (iv) administrative claim for unpaid rent for the period between the filing of the bankruptcy petition and the rejection of the lease. The Bankruptcy Code limits the "rejection damages" portion of that claim. Calculating that cap has been the subject of differing court decisions.

A recent decision in the Southern District of New York, splitting from other decisions in that district, embraced an approach to calculating a landlord's rejection claim which generally favors debtors, to the detriment of landlords.

This alert focuses on calculating the amount of "rejection damages" and discusses that recent decision. Additionally, addressing other potential avenues for recovery, it discusses application of security deposits and the landlord's rights against guarantors.

Calculating the Cap on Landlord's Rejection Damages under 11 U.S.C. § 502(b)(6)

A landlord's "rejection damages" claim is limited to "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," from the earlier of the bankruptcy filing or the date the landlord repossesses (or tenant surrenders) the premises. [1]

Courts differ on whether the reference to "15 percent" corresponds to the total rent that would have been owing during the remaining term of the lease (the "rent approach") or to the rent that would have been owing for the first 15 percent of the remaining term of the lease (the "time approach"). The difference is particularly significant where the rent increases during the term of a long-term lease. If the rent increases over the term of the lease, the "rent approach" favors the landlord and the "time approach" favors the debtor. In a recent decision,[2] Bankruptcy Judge Michael J. Wiles of the Southern District of New York, split from prior decisions from that Court and applied the "time approach" instead of the "rent approach".

Judge Wiles notes that prior decisions in the Southern District of New York applied the "rent approach".[3] When those prior cases were decided, the "rent approach" may have been the "majority" view across the country but, as Judge Wiles points out, since the most recent of those cases, "the weight of the relevant authorities in other districts has shifted very strongly in favor of the Time Approach."[4]

Based on those recent cases and his analysis of the language of section 502(b)(6), which he found to be entirely "worded in terms of periods of time," Judge Wiles found that the section "impose[s] a limit on allowable damages that is computed by reference to a period of time," and "[t]hat period of time is equal to 15 percent of the remaining time of the lease, so long as that period is more than one year but less than three years." [5]

Pursuant to this decision, a landlord's rejection claim is determined by calculating the rents reserved under the subject lease for the first 15% of the remaining lease term, as long as, that amount is not less than the rents reserved for the first remaining year of the lease and is not greater than the rents reserved for the first three remaining years of the lease.[6]

Security Deposits and Landlord's Rights against Guarantors

A security deposit being held by a landlord should generally be applied to reduce landlord's pre-petition claims for lease arrearages and lease rejection damages as capped by section 502(b)(6) but not any amounts over that cap or any post-petition rent obligations.[7]

Additionally, the landlord may be able to recover against a guarantor of a rejected lease. However, the amount of that claim against a guarantor depends on whether that guarantor is also a bankruptcy debtor. Courts will likely apply the section 502(b)(6) cap to any claims by the landlord against guarantors which themselves are debtors in bankruptcy cases. On the other hand, the section 502(b)(6) cap is unlikely to apply to limit non-debtor guarantor's liability since "common sense dictates that the guarantor remain fully liable even when the principal debtor seeks relief under the Bankruptcy Code," because "what good is a guaranteed lease if the guarantor escapes liability when the debtor does?"[8] The bankruptcy court is a court of equity balancing interests and seeking justice for creditors and debtors.

A tenant's bankruptcy filing and potential rejection of a lease certainly provides the debtor with significant control. However, the landlord is not without rights and has potential claims against the debtor-tenant and guarantors. Understanding the landlord's rights and the scope of its claims requires a careful analysis of the parties' relationship and understanding of the applicable law which may vary based on the jurisdiction. Landlords should seek advice of experienced counsel to guide them through the process.

Please note this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding this alert, please contact Michael H. Traison (mtraison@cullenllp.com) at (312) 860-4240 or Michael Kwiatkowski (mkwiatkowski@cullenllp.com) at (516) 296-9144.

Footnotes

[1] 11 U.S.C. § 502(b)(6).

[2] *In re Cortlandt Liquidating LLC*, Case No. 20-12097 (MEW), 2023 WL 1483783 (Bankr. S.D.N.Y. Feb. 2, 2023).

[3] *See* 2023 WL 1483783, *2-3 (*referencing In re Fin. News Network, Inc.*, 149 B.R. 348 (Bankr. S.D.N.Y. 1993), *In re Andover Togs, Inc.*, 231 B.R. 521 (Bankr. S.D.N.Y. 1999), and *In re Rock & Republic Enters.*, 2011 WL 2471000 (Bankr. S.D.N.Y. June 20, 2011)).

[4] *Id*. at *3 (citing numerous cases and referencing treaties). Judge Wiles also noted that legislative history supports the "time approach". *Id*. at *4-5.

[5] *Id*. at *3.

[6] Notably, the amount of landlord's claim may be reduced if the landlord mitigates its damages by reletting the premises. While a landlord may not be obligated to mitigate its damages (for example, in New York, a landlord is generally not obligated to mitigate its damages by reletting commercial premises), if the landlord does relet, the resulting rent may reduce the landlord's total rejection damages, but not the amount capped by section 502(b)(6). As such, if the landlord relets the premises, the allowed claim will be the lesser of landlord's total rejection damages (as reduced by the resulting rent from reletting) or the amount of the section 502(b)(6) cap.

[7] Courts may treat other forms of security held by landlords, such as letters of credit, differently from security deposits. Whether courts treat proceeds of a letter of credit differently from security deposits will depend on the jurisdiction and may turn on the terms of the lease. For example, if the lease provides that the parties intended to have the letter of credit serve the same function as a security deposit (*i.e.*, "letter of credit is in lieu of tenant's cash security obligation"), the court is more likely to treat it as a security deposit.

[8] *Bel-Ken Assocs. Ltd. P'ship v. Clark*, 83 B.R. 357, 359 (D. Md. 1988). *See also In re Modern Textile, Inc.*, 900 F.2d 1184, 1191 (8th Cir. 1990) ("[T]he liability of a guarantor for a debtor's lease obligations is not altered by the Trustee's rejection of the lease.").

Practices

- Bankruptcy and Creditors' Rights

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