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New York Bankruptcy Court Adopts Debtor Friendly Method to Calculate Lease Rejection Claims

A recent decision from the Southern District of New York Bankruptcy Court ("SDNY") is a boon to debtor tenants at the expense of their landlords. In his February 2, 2023 opinion, the Honorable Michael E. Wiles in *In re Cortlandt Liquidating LLC, et al*., Case No. 20-12097-MEW (Bankr. S.D.N.Y. Feb. 2, 2023), deviated from SDNY precedent and endorsed the debtor favorable "time approach" to calculate lease rejection damages under Section 502(b)6) of the Bankruptcy Code.

Section 502(b)(6)(A) of the Bankruptcy Code establishes the formula to calculate landlords' damages for lease rejection claims. It limits a landlord's damages arising from a lease terminated prior to or during a bankruptcy to the rent reserved under such lease "*for the greater of one year, or 15 percent not to exceed three years*, of the remaining term of such lease…"

Two approaches have emerged among courts to calculate the "15 percent" of the remaining lease term. Historically, the majority view (including the SDNY) utilized the "rent approach" interpreting the 15% as applying to the **total amount** payable pursuant to the lease under the **entire** remaining lease term, by which the amount of damages is capped at the greater of one year's rent or 15% of the remaining rent due. As the aggregate sum of all rent due over the entire remaining lease term is used as the base on which the 15% is calculated, this approach often results in a greater recovery for landlords since it encapsulates any escalations in rent under the lease that may be beyond the three-year period.

In contrast, historically, the minority utilized the "time approach" to calculate lease rejection damages.Under this approach, the landlord's claim is capped at an amount equal to the aggregate rent due 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 (effectively utilizing the rent due for next three (3) years of the lease). This "time approach" is more favorable to the debtor, because it does not capture any escalations in rent under the lease that may occur in later years, which is commonly found in long-term leases.

In *Cortlandt*, the Plan Administrator argued that the debtor-friendly "time approach" should apply, while the landlord argued in favor of the landlord-friendly "rent approach". Judge Wiles noted that although previous SDNY decisions applied the "rent approach," in the ten years since the entry of the last SDNY decision on this issue, other courts have shifted in favor of the "time approach." Judge Wiles noted that, in fact, since 2012, all of the reported decisions on this issue concluded that the "time approach" was the appropriate method to calculate lease rejection damages.

First, the Court held that the plain language of Bankruptcy Code section 502(b)(6) makes clear that the "time approach" is the correct interpretation since the entire phrase is worded in terms of periods of time. The Court found that the terms "one year", "three years" and "15 percent" modify the words "of the remaining term of such lease". The result is to impose a limit on allowable damages that is computed by reference to a period of time – *i.e.*, 15% of the remaining term of the lease, so long as that period is more than one year but less than three years.

Second, the Court found that the legislative history of Bankruptcy Code section 502(b)(6) supports the "time approach." Judge Wiles relied on the summary of the legislative history that was incorporated in *In re Filene's Basement, LLC,* 2015 Bankr. LEXIS 1350, at *14-17 (Bankr. Del. 2015), which was set forth in *In re Connectix Corp.,* 372 B.R. 488, 493-94 (Bankr. N.D. Cal. 2007). The *Connectix* decision from the Northern District of California concluded that the 2005 amendments to Bankruptcy Code section 502(b)(6) did not indicate that Congress intended to move away from calculating the cap based on the rent that would become due within the time period immediately succeeding the statutory trigger date.

Third, Judge Wiles disagreed with those courts that have held that considerations of equity and fairness favor the "rent approach" over the "time approach" since it better implements Congressional intent or the purposes of Bankruptcy Code section 502(b)(6). He found that the clear intent of Section 502(b)(6) was to limit landlords' lease rejection claims.

Thus, the Court held that the landlord's lease rejection damages should be calculated by reference to the rents reserved under the relevant leases for 15% of the remaining lease terms, *provided*, that such amounts shall not be less than the rents reserved for the first remaining year of the relevant lease term, and shall not be greater than the rents reserved for the first three remaining years of the relevant lease term.

While the *Cortlandt* decision is not precedent, as the Second Circuit has not weighed in on this issue, it does demonstrate a palpable shift in the SDNY in favor of the debtor-friendly "time approach" to calculating lease rejection damages. Landlords filing claims in New York should be aware of the SDNY's willingness to adopt the "time approach" which ultimately may reduce their lease rejection claims.

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