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It's Time for a New Damages Calculation: SDNY Bankruptcy Court Applies the Time Approach to Limit Damages in Lease Terminations

March 31, 2023

By **Eric G. Waxman**
Counsel | Financial Restructuring

By **Andrew M. Greenberg**
Associate | Financial Restructuring

Since 1993, decisions out of the U.S. Bankruptcy Court for the Southern District of New York consistently adopted the aggregate "rent approach" for calculating lease rejection damages in bankruptcy proceedings. But in Bankruptcy Judge Wiles' recent decision in *In re Cortlandt Liquidating LLC*, he departed from the "rent approach" in favor of the "time approach," which is based on the time remaining under the lease rather than factoring in the total or aggregate rent still owed under the lease. The *Cortlandt* decision is aligned with the trend in the case law and may indicate how lease rejection damage claims will be calculated in Southern District of New York bankruptcy proceedings moving forward.

By way of background, in order to limit the dilution of the general unsecured creditor claim pool by large damage claims resulting from a debtor-tenant's rejection of an unexpired lease, Congress capped the damages recoverable for lease rejections in bankruptcy cases. The current formulation of that cap is codified in Bankruptcy Code section 502(b)(6): "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. . . ." (Emphasis added.)

The "one year" component is readily determined − the rent for the year following the petition date or surrender or repossession of the leasehold. Landlords and tenants dispute the calculation of the "15 percent" component. The rent approach to calculating lease rejection damages, preferred by landlords, imposes a cap on damages determined by a percentage of the rent owed for the entire remainder of the lease term − such percentage is equal to 15 percent of the total dollar amount of rent still owed, so long as that dollar amount is at least equal to the rent reserved for one year and does not exceed the rent reserved for the next three years. The rent approach captures rent escalation amounts arising later in the lease term.

By contrast, the time approach, favored by debtor-tenants and non-landlord general unsecured creditors, calls for a temporal limit equal to the rent reserved under the lease for the next 15 percent of the remaining term, so long as that time period is at least one year and does not exceed three years. The time approach effectively excludes rent escalation amounts arising later in the lease term.

As Judge Wiles notes, the differences between the time approach and the rent approach are irrelevant in cases where it is clear that the section 502(b)(6) cap must be based either on the one-year rent minimum or the three-year rent maximum. However, where the damages fall somewhere in between, the time approach's calculation will, to the detriment of impacted landlords, not capture periodic rent escalations built into long-term leases.

Despite the Southern District applying the rent approach as recently as 2011, Judge Wiles grounded his decision in the plain meaning of section 502(b)(6). According to Judge Wiles, Congress' intent to cap damages by reference to time is evident in their use of the words "one year" and "three years" to modify the phrase "of the remaining term of such

lease." Therefore, "15 percent" must be read to further modify the same phrase. Judge Wiles was further persuaded by the fact that other courts and noteworthy bankruptcy treatises have withdrawn support for the rent approach since the SDNY decision in 2011.

Additionally, Judge Wiles was unconvinced by arguments based on principles of equity and fairness, explaining that perceptions of equity and fairness will change depending on perspective − landlords may find the time approach unfair or inequitable, while other unsecured creditors would likely take the opposite view. In Judge Wiles' view, the fact that there is a cap on lease rejection damages in the first place shows that Congress intended to limit landlords' claims and "Congress plainly sought to strike a balance between the interests of landlords and other creditors, whose claims might be diluted if landlords were allowed to assert very large lease termination claims."

Much to landlords' dismay − especially in a year that brings with it a degree of financial stress − application of the time approach could result in landlords recovering a smaller sum than they would under the rent approach. However, judges presiding over future bankruptcy cases in the Southern District of New York will not be bound by Judge Wiles' adoption of the time approach, and therefore it remains to be seen whether future decisions will follow Judge Wiles' lead or revert to the previously used rent approach.

Landlords may be assuaged somewhat by Judge Wiles' additional determination that certain tenant obligations that arise independent of the termination of the lease, such as repair obligations and mechanic's lien claims, are not subjected to the capped breach damages provision.

The Cadwalader team will continue to monitor future cases in this area and provide updated insights on any such developments as they arise.