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Feature

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Cortlandt May Signal Acceptance of the "Time Approach" on Landlord Future Rent Claims

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For decades, judges, academics, commentators and practitioners have debated and disagreed over various issues concerning the calculation and payment of a landlord's allowed claim in bankruptcy.[1] One such issue is whether the "rent approach" or "time approach" should be used in the "15 percent calculation" for a landlord's capped claim for "damages resulting from termination" under § 502(b)(6) of the Bankruptcy Code after a real property lease has been terminated or rejected.

On the one hand, debtors and other proponents of the time approach primarily argue that the statute's plain language shows that the 15 percent calculation refers to the *amount of time* remaining under the lease after termination. On the other hand, landlords and other proponents of the rent approach argue that applying the 15 percent calculation to the *amount of rent* remaining under the lease after termination comports more fully with equity and legislative intent to compensate landlords for their losses by accounting for bargained-for rent escalations.

Despite the uncertainty surrounding the 15 percent calculation issue, there is one area of consensus: The "statute [is] anything but clear."[2] Bankruptcy courts from across the nation have taken different sides, and there is no binding appellate-level authority that has squarely addressed the issue of whether the time approach or rent approach is the correct calculation for the "rent cap."[3] In fact, the often-cited *Collier's* treatise has changed positions on its previously adopted approach.[4] The ambiguity surrounding the 15 percent calculation issue can be frustrating and concerning for clients forced to settle or litigate over what, at first glance, appears to be a simple "black and white" mathematical calculation.

In *Cortlandt*,[5] Hon. **Michael E. Wiles** of the U.S. Bankruptcy Court for the Southern District of New York (SDNY) recently adopted the time approach, which represents a divergence from previous decisions from the SDNY that unanimously applied the rent approach. Only time will tell whether the tides have truly changed, such that other judges will follow *Cortlandt*'s lead in moving away from the previously described "majority" rent approach and adopt the time approach.

Statutory Framework, and the Rent and Time Approaches

Section 365(a) authorizes a debtor in possession (DIP) or trustee to assume or reject an unexpired lease.[6] To assume a lease, the DIP must cure any arrears or defaults, and demonstrate adequate assurance of future performance under that lease.[7] However, if a DIP rejects a lease, that rejection results in a court-authorized breach[8] of that lease,

1 Although outside the scope of this article, there is considerable debate over whether courts should apply the "proration approach" or "billing-data approach" regarding the payment of landlords' "stub rent" pursuant to § 365(d)(3).
2 *In re Gantos Inc.*, 176 B.R. 793, 795 (Bankr. W.D. Mich. 1995).
3 However, without specifically addressing the two approaches, the Ninth Circuit Court of Appeals appears to have adopted the time approach. *See In re El Toro Materials Co. Inc.*, 504 F.3d 978, 980 n.3 (9th Cir. 2007) ("The cap maxes out at 15% of 20 years, or [three] years' rent."). Similarly, although the Third Circuit Court of Appeals has not ruled on the issue, it explained in *dicta* that a landlord-creditor "is entitled to rent reserved from the greater of (1) one lease year or (2) [15] percent, not to exceed three years, of the remaining lease term." *In re PPI Enters. (U.S.) Inc.*, 324 F.3d 197, 207 (3d Cir. 2003).
4 *See In re Cortlandt Liquidating LLC*, 648 B.R. 137, 140 (Bankr. S.D.N.Y. 2023) ("The *Collier's* Treatise now also endorses the Time Approach rather than the Rent Approach."); *Collier on Bankruptcy* ¶ 502.03[7][c] (16th ed. 2022).
5 *Cortlandt*, 648 B.R. 137.
6 11 U.S.C. § 365(a).
7 11 U.S.C. § 365(b).
8 *See* 11 U.S.C. § 365(g).

which excuses the DIP from future performance and entitles the landlord to an unsecured-damages claim, including damages arising from the rejection of the lease (*e.g.*, future rents) that are statutorily capped. The calculation of the rent cap on damages resulting from lease termination is governed by § 502(b)(6)(A), which provides:

> [I]f such objection to a claim is made, the court ... 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 — (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.

The longstanding debate over the rent approach or time approach pertains to whether the "15 percent" should be applied to the amount of rent remaining due under the lease after termination, or the amount of time remaining under the lease after termination, respectively. The 15 percent calculation would only be applicable if the remaining term of the lease is between 80 months (where the calculation will result in a claim greater than the one-year rent minimum) and 240 months (where the calculation will result in a claim less than the three-year rent maximum).[9]

Further, the time and rent approaches would only yield differences in the amount of the rent cap if the lease contains a rent-escalation clause providing for periodic increases of rent, as the time approach "imposes a cap that is based on rents that are specified for the first 15% of the remaining lease term [and] ignores rent escalations that would occur in later years." In contrast, the rent approach "imposes a cap that is based on 15% on all of the rents that are specified for the entire remaining leas[e] term ... thereby captur[ing] an element of rent escalations that the Time Approach does not capture."[10]

For example, if a lease simply has 10 years remaining at a base rate of $500 per month, both the time and rent approaches would result in the landlord receiving a capped claim for rejection damages in the amount of $9,000 ($500 multiplied by 120 months multiplied by 15 percent). In contrast, where that same lease has a base rate of $500 per month after rejection, with annual rent escalations of $100: (1) under the time approach, the 15 percent would be applied to the remaining term of the lease (*i.e.*, 18 months), and the landlord's capped claim would be $9,600 (sum of $500 multiplied by 12 months, and $600 multiplied by six months); and (2) under the rent approach, the 15 percent would be applied to the remaining amount of rent owed under the lease, and the landlord's capped claim would be $17,100 ($114,000 multiplied by 15 percent). Although this hypothetical only shows a $7,500 difference between the two approaches, in leases that have much larger base rent and rent-escalation amounts, and longer remaining lease terms, the calculations under these approaches can yield drastically different amounts for capped lease-rejection claims, often in the hundreds of thousands, if not millions, of dollars.

Cortlandt's Adoption of the Time Approach

Cortlandt involved the chapter 11 debtor's plan administrator's objection to proofs of claim filed by two landlords. Prior to reassignment of the bankruptcy case to Judge Wiles, Hon. Shelley C. Chapman (ret.) entered interim orders holding, among other things, that the leases had terminated for purposes of calculating the landlords' claims for rejection damages pursuant to § 502(b)(6), and directing the parties to meet and confer regarding that calculation. Judge Wiles was subsequently informed by the parties that they could not agree on, among other issues, whether the rent cap should be calculated according to the time approach or rent approach and whether certain other types of damages are subject to the rent cap.

With respect to the first issue, the court agreed with the plan administrator and ruled that the time approach (and not the rent approach) was correct for determining the rent cap pursuant to the 15 percent calculation. In so ruling, the court stated that it did "not lightly depart from prior precedent in this District,"[11] which previously adopted the rent approach, and gave three primary reasons.

First, the court found that the plain language of § 502(b)(6), which is "worded in periods of time," "makes clear that the Time Approach is the correct one."[12] Specifically, it reasoned that if Congress intended for the 15 percent calculation to apply instead of a dollar amount, it could have done so explicitly, and the "words '15 percent' would not have been sandwiched between two other time periods [*i.e.*, 'one year' and 'three years'], and they would not have been used as a modifier of the phrase 'of the remaining term of such lease.'"[13]

Next, the court analyzed § 502(b)(6)'s legislative history and concluded that because there is nothing to indicate that Congress intended to depart from the pre-Code practice of calculating future rent damages as a function of time, the time approach was the correct one. Specifically, the court quoted a House Judiciary Report from an earlier version of the statute (that § 502(b)(6) replaced), which stated that "[t]he damages a landlord may assert from termination of a lease are limited to the rent reserved for the greater of one year or 10 percent of the remaining lease term, not to exceed three years after the earlier" of the petition date or the date of surrender or repossession.[14]

Lastly, the court concluded that "considerations of equity or fairness" (which some courts have argued favor the rent approach) do not favor one approach or the other, as Congress in enacting § 502(b)(6) only "sought to strike a balance between the interests of landlords and the interests of other creditors, whose claims might be diluted if landlords were allowed to assert very large lease termination claims."[15] As a result, it opined that "[f]rom the point of view of landlords ... any interpretation of the statute that results in a lower cap ... might be

9 *See* 3 *Bankruptcy Law Manual* § 16:19, "Rejection of Executory Contract — Calculation of Claim" (December 2022 Update); *In re Iron-Oak Supply Corp.*, 169 B.R. 414, 419 (Bankr. E.D. Cal. 1994).
10 *Cortlandt*, 648 B.R. at 140.
11 *Id.* at 141.
12 *Id.*
13 *Id.* The court cited, among other decisions, *In re Heller Ehrman LLP*, No. 10-CV-03134 JSW, 2011 WL 635224, *3 (N.D. Cal. Feb. 11, 2011), which opined that "in comparing the greater or lesser of two things, the measurements of those things must be parallel, *e.g.*, time versus time."
14 *Cortlandt*, 648 B.R. at 143 (citing H.R. Rep. 95-595 at 353, 1978 U.S.C.C.A.N. 5963, 6309).
15 *Id.*

considered unfair or inequitable. On the other hand, from the point of view of other creditors ... any interpretation of the statute that results in a higher cap (and therefore a larger allowed landlord claim) would be regarded as unfair or inequitable."[16]

Despite losing on the first rent vs. time approach issue, not all was lost for the landlords in *Cortlandt*. The court rejected the plan administrator's argument that the rent cap "applies to all damages of any kind that are sought by a landlord," and instead agreed with the narrower test[17] adopted by the Ninth Circuit in *El Toro* to determine the kind of damages that are subject to the rent cap. Specifically, the court found that except for the cleanup costs, none of the "additional damages" asserted by one of the landlords (*e.g.*, mechanics' liens, window repairs and other repairs) were subject to the rent cap.[18]

SDNY Precedent and the Rent Approach

The *Cortlandt* decision represents a stark departure from prior SDNY precedent (*i.e.*, three[19] decisions spanning over 20 years, consisting of *Financial News Network*,[20] *Andover Togs*[21] and *Rock & Republic Enters.*[22]) that applied and/or adopted the rent approach. Both *Financial News Network* and *Rock & Republic Enters.* contain very little reasoning as to why the rent approach was found to be the correct one. In fact, the primary issue decided in *Financial News Network* was different (*i.e.*, whether certain post-petition rent payments made by the debtor should be deducted from the rent cap), and the court — despite ruling that the landlord correctly calculated its 15 percent capped claim using the rent approach — did not even acknowledge that there were two approaches for doing so.[23] Similarly, the *Rock & Republic Enters.* court did not provide any substantive reasoning for adopting the rent approach and simply stated that it declined to depart "from longstanding authority adopted in this jurisdiction."[24]

However, *Andover Togs* specifically addressed the split in authority regarding the rent and time approaches, concluding that the "majority" rent approach was the "logically sounder approach."[25] The court relied heavily on the out-of-district *Gantos* decision,[26] which adopted the rent approach, because, among other reasons, it is more equitable to base "rejection damages on the total rent bargained for," because "landlords assume the risk that their lessors may file [for] bankruptcy [and] they should not be stripped of any bargained-for benefit in the terms of the leasing agreement,"[27] and the rent approach is the "most natural" interpretation of the statutory language.[28]

Implications of *Cortlandt*?

Practitioners should familiarize themselves with the *Cortlandt* decision and take caution when relying too heavily on prior precedent from the SDNY that has applied and/or adopted the previously described "majority" rent approach. Although only time will reveal whether *Cortlandt*, a nonbinding decision, will sway other bankruptcy judges within the SDNY and across the nation to move away from the rent approach and adopt the time approach, what is clear is that the debate continues.[29] Unless the statute is amended or binding case authority develops, the 15 percent calculation for the rent cap will remain a disputed issue across the jurisdictions rather than a simple mathematical calculation. abi

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16 *Id.*
17 "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?" *El Toro*, 504 F.3d at 980-81.
18 *Cortlandt*, 648 B.R. at 147.
19 *Id.* at 141 ("[T]here are no other relevant decisions in this District with respect to this issue.").
20 *In re Fin. News Network Inc.*, 149 B.R. 348 (Bankr. S.D.N.Y. 1993).
21 *In re Andover Togs Inc.*, 231 B.R. 521 (Bankr. S.D.N.Y. 1999).
22 *In re Rock & Republic Enters. Inc.*, No. 10-11728 AJG, 2011 WL 2471000 (Bankr. S.D.N.Y. June 20, 2011).
23 *See Fin. News Network*, 149 B.R. at 351-52.
24 *See Rock & Republic Enters.*, 2011 WL 2471000, at *20.
25 *Andover Togs*, 231 B.R. at 545-47.
26 *Gantos*, 176 B.R. at 796.
27 *Id.*
28 *Id.* ("[T]he statute allows for lease-rejection damage claims with a damage cap based on rent and time.... The 15% quantifies the aggregate rent remaining and not the time remaining under the lease.").
29 However, recent bankruptcy court decisions appear to favor using the time approach. *See, e.g., Heller Ehrman LLP*, 2011 WL 635224; *In re Filene's Basement LLC*, No. 11-13511 (KJC), 2015 WL 1806347 (Bankr. D. Del. April 16, 2015).