Lease Rejection: Understanding the Capped and Uncapped Claims of a Landlord in Bankruptcy

Christopher M. Candon and Jaclyn N. Fisher

Candon

Fisher

For businesses of all sizes, the cost associated with its office or retail space is a significant expense. This reality may be even more accentuated for small businesses that are tied to long-term lease obligations, resulting in the landlord being one of the largest and/or most influential creditors of the business. For the past 16 months, the COVID-19 pandemic has challenged businesses and landlords in navigating never-before experienced economic pressures. Many businesses were forced to shut their doors, unable to meet ongoing rent and other obligations, while others managed to get by and, with respect to rent obligations, negotiated lease modifications to provide some temporary relief. But now as stimulus funds are no longer as readily available, businesses may be faced with mounting pressure to pay postponed rent obligations while staying current on existing monthly rent and all other business obligations. If this burden is too much, businesses may be forced to consider bankruptcy in order to restructure debt and/or reject burdensome leases.

To properly evaluate a bankruptcy filing (or the threat of a tenant bankruptcy filing), both the business tenant and landlord need to understand how the Bankruptcy Code will treat a landlord's claim resulting from the termination of a lease of real property. Absent such understanding, any pre-bankruptcy negotiations may not be productive.

Under Section 502(b)(6) of the Bankruptcy Code, claims for damages resulting from the termination of a lease (i.e., lease rejection claims) may not exceed the amount of "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…." Not surprisingly, the courts have struggled in applying this formula, largely settling on two approaches – the rent and time approaches.

The Rent and Time Approaches

Courts that have adopted the rent approach permit the landlord to compute the total amount of rent due for the remainder of the lease term and multiply that amount by 15 percent. This results in a capped claim for damages at a maximum of 15 percent of the total rent due for the remainder of the lease term. Although not universally applied, some courts hold that if the 15 percent amount exceeds the total amount of rent due under the lease for the next three years, the three-year amount would be the capped claim.

In the alternative time approach, courts view the 15 percent marker as a measure of time remaining under the lease term. In other words, the damages claim would be capped at the amount of rent due for the first 15 percent of the time remaining under the lease, such time period not to exceed three years.

In practical application, the mechanism for calculating the landlord's capped claim for damages can be summarized as follows:

- Establish the "start date," which is the earlier of (i) the date the bankruptcy case commenced, or (ii) the date on which the premises were repossessed by the landlord or surrendered by the tenant (herein, the "Cap Commencement Date").
- Determine the projected amount of all rent charges that will come due for the year commencing on the Cap Commencement Date.
- Using the rent approach, determine all projected rent charges that will come due for the remaining term of the lease, and multiply by 15 percent. Then, determine all projected rent charges that will come due for the three-year period commencing on the Cap Commencement Date. Whichever amount (the 15 percent computation or the three-year computation) is greater will be the governing amount of the cap.
- Using the time approach, determine the number of months remaining on the term of the lease, and multiply by 15 percent. The number of months is limited to 36 months ("not to exceed three years"). Then, determine the amount of rent for those months.
- Whichever of the two "caps" (the one-year cap vs. the 15 percent/three-year cap), calculated as provided above, results in a greater claim is the cap that will be utilized in computing the capped rejection damage claim.

Not All Damages Are Subject to the Cap

However, while much attention is given to the calculation of the capped claim, a landlord's claim may involve more than just damages resulting from the termination of the lease and subject to the Section 502(b)(6) cap. Clearly, a landlord is entitled to an unsecured claim for all amounts due and owing under the lease through the earlier to occur of its termination or the filing of the bankruptcy petition. This component of a landlord's claim is not subject to the "cap."

More controversially, courts have been divided on the issue of whether or in what instances less obvious claims result from the termination of the lease and, thus, are limited by the cap. For example, would a landlord's claim for maintenance and repair costs associated with its rejected property lease be subject to the cap? What about the costs associated with the removal of a mechanic's lien?

A landmark bankruptcy case provided guidance to the interpretation and application of the Section 502(b)(6) cap. In Saddleback Valley Community Church v. El Toro Materials Co. (*In re El Toro Materials Co, Inc.*), 504 F.3d 978 (9th Cir. 2007), the Ninth Circuit ruled that tort claims against the debtor tenant for collateral damages (i.e. damages unrelated to the loss of rental income) to the property were not subject to the cap under the Bankruptcy Code. In so ruling, the Ninth Circuit buttressed the courts that held the cap to be inapplicable to claims for a tenant's breach of repair and maintenance obligations and cast doubt on the viability of the line of cases that held otherwise.

Since the *El Toro* case, many courts moved away from the once-held precedent that the Bankruptcy Code creates a broad cap on rejection damages in favor of what is now referred to as the "El Toro" test. More recently, the Ninth Circuit ruled again that the Bankruptcy Code does not create a cap on damages a landlord can receive for every breach of lease and rejected the "all or nothing approach," adopting the "El Toro" test for determining when

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rejection damages should be capped in bankruptcy cases. *See In re Kupfer*, 63 Banker. Ct. Dec. 136 (9th Cir. 2016). The "El Toro" test is considered a "simple" test that asks: 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 reject it?

Courts in the Third Circuit have followed the lead of the Ninth Circuit and similarly adopted the El Toro test. For now, the First Circuit has yet to adopt the El Toro test for determining what claims of a landlord are subject to the Section 502(b)(6) cap.

As the challenges of the COVID-19 pandemic continue to unfold, the burden of lease obligations may rise to the forefront. As tenants consider options, landlords must understand how claims may be treated if the tenant's possibilities include a potential bankruptcy filing and rejection of a lease. With that understanding, the landlord can consider lease modification requests or evaluate the risks of a bankruptcy filing.

Chris Candon is a member of the Management Committee and serves as the Chair of the Corporate Department at Sheehan Phinney. Chris focuses his practice on the problems of financially distressed companies, assisting clients with transactional and litigation matters involving commercial law and insolvency issues.

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(Bankr. E.D. Cal. Dec. 15, 2020) (finding that the general nature of the allegations in the trustee's complaint suggested a lack of pre-filing due diligence, it dismissed the preference action). While the court granted the trustee leave to amend the complaint, presumably the trustee would need to allege the requisite due diligence to defeat a further motion.

Another court considering a motion to dismiss on the grounds that the trustee failed to plead facts necessary to satisfy the due diligence requirement declined to reach the question. Pointing to allegations in the complaint that noted the trustee had reviewed bank and wire records and invoices relating to the preference defendant transactions with the debtor, the court found that enough had been done to reach the prerequisite if one exists. *See In re Trailhead Eng'g LLC*, No. 18-32414, 2020 WL 7501938 (Bankr. S.D. Tex. Dec. 21, 2020).

Together, these opinions suggest that if a complaint is filed with no demand letter having been sent and it is lacking allegations that establish the trustee has assessed defenses, raising the issue will be a valuable tool to reach a better resolution for the defendant.

Recognizing the burden on defendants to defend away from their home jurisdiction, the SBRA also amended Section 1409(b) of Title 28, a venue provision, increasing the monetary threshold from $13,650 to $25,000. Actions to recover a non-consumer debt against a non-insider defendant below that amount must be brought where the defendant resides, not where the bankruptcy case is pending. It is unclear if the provision applies to preference actions and while the weight of authority suggests no, some courts have indicated it does. Compare *In re Munson, Inc.* 627 B.R. 507 (Bankr. C.D. Ill. 2021), with *Dynamerica Mfg. LLC v. Johnson Oil Co., LLC*, No. 08-11515 (KG), 2010 WL 1930269 (Bankr. D. Del. May 10, 2010). Raising venue in a smaller dollar case may also help achieve a favorable result.

Finally, newly enacted Section 547(j) provides a safe harbor for commercial landlords and sellers of goods and services who choose to work with businesses impacted by the pandemic. A debtor or trustee may not avoid payments (other than fees, penalties, or interest the debtor would have owed without the deferral) made by a debtor during the preference period for rent or supplier arrearages provided that the debtor and creditor amended the lease or contract after March 13, 2020, and the amendment deferred or postponed payments that were otherwise due under the lease or contract. The provision sunsets on Dec. 27, 2022, but still applies to cases filed before that date.

Joseph A. Foster chairs and Christopher M. Dube is a member of McLane Middleton's Bankruptcy Practice Group. Joseph can be reached at (603) 628-1175 or joe.foster@mclane.com. Christopher can be reached at (603) 628-1437 or christopher.dube@mclane.com .

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Stars however: *In re Trepetin*, 617 B.R. 841 (Bankr. MD. 2020) (extending deadlines because debtor acted timely in filing his requested extensions in connection with the conversion of his Chapter 7 and since a Chapter 7 debtor is not required or permitted to file a plan, the debtor has not been dilatory in the plan process itself and appears to have complied with all his obligations under Chapter 7 of the Code); *See also, In re Ventura*, 615 B.R. 1, 6 (Bankr. E.D.N.Y. 2020) and *In re Twin Pines*, LLC, 2020 Bankr. LEXIS 1217 (Bankr. NM 2020) (debtor, who commenced its Chapter 11 case as a small business case approximately one year before the SBRA went into effect, could amend its petition to elect subchapter V treatment 387 days after commencing the bankruptcy case, with the court exercising its discretion to grant an extension of the deadlines).

In conclusion, with an increasing number of Subchapter V cases will come good court decisions allowing debtors, creditors, attorneys and judges to better administer Subchapter V cases for the benefit of small business and individual debtors.

Jim is a Partner at Sheehan Phinney and the Practice Group Leader of the Firm's Bankruptcy, Restructuring and Creditor's Rights Group. Jim's diverse practice includes the representation of debtors and creditors involved in bankruptcy, financially distressed situations, and commercial disputes.