Setting the Clock on the Section 502(b)(6) Time vs. Rent Debate

Delaware Bankruptcy Court Provides Clarity on the Meaning of "15 Percent"

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The Bankruptcy Code offers a debtor myriad tools to facilitate an effective reorganization. Two of the most fundamental devices include the permissive revaluation of executory contracts and unexpired leases under § 365 and the reconciliation of claims against the estate under § 502. While factually distinct, the intersection of the two sections has sparked a great deal of litigation and academic debate. One particular point of contention centers on the application of § 502(b)(6)'s cap of a landlord's claim for a bankrupt tenant's rejection of a nonresidential lease. On April 16, Judge Kevin J. Carey of the U.S. Bankruptcy Court for the District of Delaware issued an opinion in *In re Filene's Basement* that should curtail at least a portion of the dispute.

Background

Filene's Basement historically owned and operated off-price retail stores throughout the country. In November 2011, the company filed a petition under Chapter 11 of the Bankruptcy Code to finalize its affairs and to maximize the value of its real estate for the benefit of creditors.

Prior to the petition date, Filene's leased retail space in Washington, D.C., pursuant to a lease agreement with Connecticut/DeSales LLC as landlord.[1] In December 2011, Filene's rejected the lease pursuant to Bankruptcy Code § 365.[2] Absent rejection, the lease would have expired on Jan. 31, 2019.[3]

Following rejection of the lease, the landlord timely filed a proof of claim against Filene's for, among other things, rejection damages, subject to the Bankruptcy Code § 502(b)(6) cap.[4] The landlord calculated the statutorily capped rejection damages as the total rent due for the remaining term multiplied by 15 percent.[5] Filene's objected to the claim on the basis that § 502(b)(6) caps rejection damages at 15 percent of the remaining term of the lease rather than at 15 percent of the remaining rent due under the lease. The difference in the parties' respective positions represented approximately $105,000.

Bankruptcy Code § 502

Pursuant to Bankruptcy Code § 365, a debtor in a bankruptcy proceeding may reject any unexpired lease of nonresidential real property.[6] Although the Bankruptcy Code does not specify the standard by which to assess a debtor's decision to reject a lease, courts typically use a business judgment test and refrain from second guessing the debtor if rejection will benefit the estate.[7] If a debtor carries its burden on rejection, the lease is deemed to have been breached, and the debtor is relieved from future performance.[8]

Under the current Bankruptcy Code, rejection of a lease gives rise to a claim for damages in favor of the landlord. However, much of the debate in this area historically focused on what, if any, aspects of a landlord's claim should be allowed. For instance, prior to 1934, a landlord's claim for premature lease termination damages was not recognized as a viable claim, because it was considered purely contingent and incapable of proof.[9] As a result, landlords could not recoup any damages for post-termination rent. The 1934 and 1938 amendments rectified that inequity. Pursuant to the amendments, landlords received distributions for future rents, subject to certain limitations that were designed to prevent large unearned rent claims from diluting a debtor's dividend to unsecured creditors.[10] Specifically, landlord claims for future rent in liquidation cases were capped at "the year next succeeding" surrender or reentry.[11] Similarly, claims by landlords in rehabilitation cases were capped at "the three years next succeeding" surrender or reentry.[12]

The reasoning behind the lease rejection damages limitations imposed by the 1934 and 1938 amendments was carried forward in the 1978 amendments. Congress believed the earlier compromise appropriately compensated landlords for their loss while precluding a pool of substantial claims that would prevent other general unsecured creditors from recovering a distribution from the estate.[13] Eventually, the Bankruptcy Code was amended to include the current percentage calculation, which provides that a landlord's claim is limited to the rent reserved by the lease, without acceleration, for the greater of either one year or 15 percent, not to exceed three years, of the remaining lease term following the earlier of (i) the petition date and (ii) the date of surrender or reentry.[14]

The Rent vs. Time Debate and Filene's Decision

Debtors and landlords have long disputed whether § 502(b)(6)'s reference to 15 percent points to the amount of time remaining in the term of the lease or the remaining amount of rent due under the lease. It is easy to see why the varying interpretations have produced so much litigation and debate. Indeed, the difference between the two positions, as demonstrated in *Filene's,* can be significant, because leases commonly contain rent and other cost escalation clauses. Landlords commonly seek to use the rent approach to take advantage of the escalation clauses over the lifetime of the lease. In response, debtors frequently seek to cap landlord claims using the time approach, so that only those escalators applicable in the first 15 percent of the term, up to a maximum of three years, can be captured. As noted by Judge Carey in the *Filene's* decision, each position finds support in modern case law. On the one hand, courts in jurisdictions like California,[15] Colorado,[16] Florida,[17] and Pennsylvania[18] have applied the time approach. On the other hand, courts in

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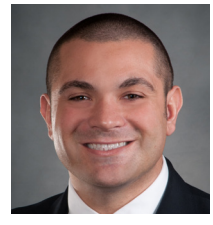

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Illinois,[19] Michigan,[20] and New York,[21] have found the rent approach to be more consistent with congressional intent.

To resolve this split, the court focused its analysis on the text of the statute—"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." Judge Carey concluded that a natural reading of this language supports utilizing the time approach over the rent approach for three reasons. First, comparing the greater or lesser of two things is only possible when using parallel units. Because the first element of the § 502(b)(6) comparison is temporal (one year), the second element (remaining term) must necessarily refer to time. Second, allowing a rent-based claim would render the "without acceleration" prohibition meaningless in situations where escalation clauses are present.[22] Finally, according to the court, the time approach is more constituent with the clear congressional intent from prior versions of the statute that expressly limited damages based on temporal measurements.

While the Third Circuit has yet to weigh in on the time vs. rent debate, the court's decision in *Filene's* likely means that debtors in Delaware can successfully foil future rent-based landlord claims.[23] However, until Congress clarifies the meaning of § 502(b)(6), a split of authority will remain, notwithstanding the *Filene's* decision.[24] As always, practitioners must know the law of the jurisdictions in which they appear for their clients. ⊙

Endnotes

[1] *In re Filene's Basement,* No. 11-13511-KJC, 2015 WL 1806347, at *1-2 (Bankr. D. Del. Apr. 16, 2015). The landlord was the successor in interest to an affiliated entity. Filene's was successor in interest to a prior tenant.

[2] *Id.* at *2.

[3] *Id.*

[4] *Id.* at *2-3.

[5] *Id.*

[6] 11 U.S.C. § 365(a).

[7] *See, e.g., Sharon Steel Corp. v. Nat'l Fuel Gas Dist. Corp.* (*In re Sharon Steel Corp.*), 872 F.2d 36, 39-40 (3d Cir. 1989).

[8] *Taylor Wharton Int'l LLC v. Blasingame* (*In re Taylor-Wharton Int'l LLC*), No. 10-52792-BLS, 2010 WL 4862723, at *3 (Bankr. D. Del. Nov. 23, 2010) (noting that rejection constitutes a pre-petition breach, not rescission of the contract).

[9] *In re Connectix Corp.,* 372 B.R. 488, 491 (Bankr. N.D. Cal. 2007).

[10] *Id.* at 492; *see also Oldden v. Tonto Realty Corp.,* 143 F.2d 916, 918 (2d Cir. 1944).

[11] *Connectix,* 372 B.R. at 492.

[12] *Id.*

[13] *Id.*

[14] 11 U.S.C. § 502(b)(6).

[15] *Connectix,* 372 B.R. at 491-93; *see also In re Iron-Oak Supply Corp.,* 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994).

[16] *In re Shane Co.,* 464 B.R. 32, 40 (Bankr. D. Colo. 2012).

[17] *In re Ace Elec. Acquisition LLC,* 342 B.R. 831, 833 (Bankr. M.D. Fla. 2005).

[18] *Sunbeam-Oster Co. v. Lincoln Liberty Ave. Inc.* (*In re Allegheny Int'l Inc.*), 145 B.R. 823, 828 (W.D. Pa. 1992); *see also In re Peters,* No. 03-11077-DWS, 2004 WL 1291125, at *6 n. 20 (Bankr. E.D. Pa. May 7, 2004).

[19] *Schwartz v. C.M.C., Inc.* (*In re Communicall Cent., Inc.*), 106 B.R. 540, 544 (Bankr. N.D. Ill. 1989).

[20] *In re Gantos Inc.,* 176 B.R. 793, 795-96 (Bankr. W.D. Mich. 1995).

[21] *In re Andover Togs Inc.,* 231 B.R. 521, 540-41 (Bankr. S.D.N.Y. 1999).

[22] The court found unpersuasive the argument that the rent approach more appropriately provides landlords the benefit of their bargain by accounting for negotiated lease escalators. Congress started with the premise that landlords had no claim at all and, unlike other unsecured creditors, enjoy the added protection of ultimately reclaiming their property. According to the court, the time approach strikes the better balance of competing economic interests by providing landlords a set period of time to relet the premises.

[23] The *Filene's Basement* decision was not appealed to the district court.

[24] The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 suggested in its Final Report and Recommendations that § 502(b)(6) should be clarified consistent with the time approach.

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Cir. 1986).

[12] *Adamson Apparel,* 785 F.3d at 1288.

[13] *Id.* at 1289.

[14] *Id.* at 1290.

[15] *Id.* at 1288.

[16] *Id.* at 1289.

[17] *Id.*

[18] *Id.*

[19] *Id.* at 1289-91.

[20] *Id.* at 1291.

[21] *Id.* (citing cases, including *Miller v. Greystone Bus. Credit II LLC* (*In re USA Detergents Inc.*), 418 B.R. 533, 541-42 (Bankr. D. Del. 2009)).

[22] *Id.*

[23] *Id.* at 1292 (quoting *Deprizio,* 874 F.2d at 1195).

[24] *Id.* (citing cases, including *O'Neil v. Orix Credit Alliance Inc.* (*In re Ne. Contracting Co.*), 187 B.R. 420, 423-24 (Bankr. D. Conn. 1995)).

[25] *Id.* at 1293 (quoting *Hendon v. Assocs. Comm. Corp.* (*In re Fastrans*), 142 B.R. 241, 246 (Bankr. E.D. Tenn. 1992)).

[26] *Id.*

[27] *Id.* at 1293-94 (noting that the "mere possibility of such avoidance does not mean that it will routinely occur.").

[28] *Id.*

[29] *Id.*

[30] *Id.* at 1295 (citing *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963, (1988)).

[31] *Id.*

[32] *Id.* at 1295-96.

[33] *Id.* at 1296.

[34] *Adamson Apparel,* 785 F.3d at 1296 (citing cases, including *Miller v. Greystone Bus. Credit II,* Note 21, *supra*).

[35] 299 B.R. 173, 177 n.3 (Bankr. N.D. Ill. 1999).

[36] *Adamson Apparel,* 785 F.3d at 1297.

[37] *Id.*

[38] *Id.*

[39] *Id.*