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Cap on Lease Rejection Claims Under the Bankruptcy Code and Its Damaging Effect on Commercial Landlords

While there is no clear resolution to the risks imposed to commercial landlords as a result of §502(b)(6), there are avenues to pursue to ensure that the claim cap does not become a claim trap.

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Creditors' and Debtors' Rights

By Sherry Millman and Genna Grossman | September 16, 2022 at 02:30 PM

When a tenant files for bankruptcy, the commercial landlord is faced with the often worrisome prospect that its unexpired lease may be rejected in the bankruptcy proceedings. A tenant's right to reject a lease, and thereby disavow its future lease obligations, does not exist outside of bankruptcy and often plays a large role in its decision to file for bankruptcy. During the period that the debtor tenant is determining whether or not to assume a non-residential lease, the Bankruptcy Code requires it to timely perform the obligations under the lease which arise after the commencement of the bankruptcy case, see 11 U.S.C. §365(d)(3)(A). However, that is not the case for lease obligations related to time periods occurring after a lease is rejected. The Bankruptcy Code creates a fiction that rejection of a lease, although effectuated post-petition, constitutes a breach which occurred immediately prior to the filing of the bankruptcy petition. See 11 U.S.C. §365(g)(1).

As a result, if an unexpired commercial lease of real property is rejected, the landlord will be left only with a pre-prepetition unsecured claim to be asserted in the bankruptcy for damages resulting from such rejection and, like other pre-petition unsecured creditors, with the attendant uncertainty about recoveries on its claim. However, unlike most other unsecured creditors, a commercial landlord is also subject to a limitation on the amount of its claim under §502(b)(6) of the Bankruptcy Code, even before it gets to the recovery stage on its claim. This provision disallows any amounts claimed by landlords for damages resulting from the termination of a lease of real property which are in excess of "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 [the petition date and the date the landlord repossessed, or the tenant surrendered, the premises]" plus unpaid rents due under such lease, without acceleration, on such earlier date. See 11 U.S.C. §502(b)(6). The formula has proven to be a brain teaser of sorts with courts and commentators grappling over, among other things, what constitutes rent for these purposes, as well as how the 15% is calculated.

What doesn't seem to have garnered as much attention is whether the limitation under §502(b)(6) is serving its intended purpose. The cap was put in place to ensure that a landlord did not receive a windfall on its long-term lease rejection claims, given that the landlord received its property back upon lease rejection and then had an opportunity to relet it. "Section 502(b)(6) was designed to compensate a landlord for the loss suffered upon termination [of an unexpired lease] but at the same time limit the recovery to a reasonable amount that would not prevent other creditors from recovering from the [debtor's] estate." *In re Leslie Fay Companies*, 166 B.R. 802, 809 (Bankr. S.D.N.Y. 1994). However, with the way many commercial lease transactions are currently structured, the opposite is happening: The cap is working to severely disadvantage commercial landlords by dwarfing their allowable claims compared to the damages incurred and to the claims of other creditors.

Under current practice, a commercial tenant will often receive, among other concessions, a "tenant allowance" under a new lease whereby the landlord will agree to bear the costs, up to a specified amount, to build out the premises to the commercial tenant's unique specifications, and then recover those significant costs by absorbing them into future rents under the lease. In the event the commercial tenant later files for bankruptcy and the applicable lease is rejected, the landlord is often at a loss with respect to out-of-pocket expenses for significant sums in connection with such construction, as well as for any broker fees it incurred when originally entering into the commercial lease. The landlord would not be able to recover those buildout costs in a lease with a new tenant, who will often require a different buildout according to its own specifications, nor the broker fees, and additional broker fees will also need to be expended in the reletting process. By way of example, an accounting or law firm, as a new tenant, will not want an open space

concept with few private offices built at the behest of a start-up tech entity which was the existing tenant. Further, even if a replacement tenant is ultimately found and a new lease is negotiated, a period of rent abatement is now a typical concession such that the rental amount anticipated during the original lease period may not be recouped through reletting the space. When tenants in bankruptcy reject their leases, commercial landlords are often finding that the out-of-pocket costs they have already incurred far exceed the capped claim amount that they are allowed to assert in bankruptcy and that the costs associated with reletting do not mitigate damages incurred, such that the cap operates as an unwarranted penalty for landlords. In short, commercial lease transactions are a lot more costly for landlords and more complicated than simply replacing the existing tenant by reletting the space as was likely envisioned when §502(b)(6) was enacted. Faced with such risks, commercial landlords may become reticent to continue with tenant allowances or long term lease arrangements or may be compelled to otherwise change the economics of the lease transactions to the detriment of their prospective tenants and the real estate community.

What is the solution? The Bankruptcy Code could be amended to reflect the realities of current commercial real estate transactions by eliminating §502(b)(6) altogether or amending it to permit the allowance of uncapped claims related to tenant allowances, brokers' commissions and other costs. At the very least, Congress could authorize a commission to study these issues to help ensure that commercial landlords, like other unsecured creditors, can also receive a fair recovery from the debtor's estate.

Unless and until such action is taken, commercial landlords can and should take steps with prospective tenants to ensure that their lease arrangements take the cap into account. These steps can include: (1) structuring any tenant allowance or improvement as a loan to bolster an argument that such amounts are presently due unpaid amounts and additional to the cap amount and/or (2) obtaining a guaranty from a credit worthy entity that is not likely to itself file for bankruptcy, to avoid any claim with respect to the guaranty also being subject to the cap. In addition, commercial landlords should consider requiring in their leases that any financials of a tenant and its guarantors delivered to the landlord during the period of any buildout be certified and submitted to the landlord on a regular and defined basis. Further, the lease should include language that in the event any delivered financials are deemed unsatisfactory to the landlord, the landlord can cease any further work on a build out and also be permitted to stop complying with any other obligations under the lease that require the landlord to lay out substantial sums of money.

Landlords often rely on their security deposits to bolster their position in the event of a tenant's bankruptcy and letters of credit are a preferred form of security deposit for that purpose. Under the "independence principle", the obligations of the issuer of the letter of credit are distinct from the obligations of the account party's estate such that a landlord can draw on a letter of credit if permitted under the terms of the lease without violating the automatic stay imposed by the account party's bankruptcy. 4 *Collier on Bankruptcy* ¶ 502.03 (16th ed. 2022). Commercial landlords should be aware, though, that security deposits, regardless of their form, will likely be applied to the §502(b)(6) capped claim amount, rather than the gross rejection claim, and take this into account when entering into lease negotiations with prospective tenants. See *In re PPI Enters. (U.S.)*, 324 F.3d 197, 209-10 (3d Cir. 2003) (holding that a letter of credit, which operated as a security deposit, was subject to the statutory cap). If a commercial landlord increases the amount of a letter of credit as a security deposit, this could serve to help balance the risk that a portion of the unsecured rejection damage claim exceeds the cap and cannot be included in the claim amount.

While there is no clear resolution to the risks imposed to commercial landlords as a result of §502(b)(6), there are avenues to pursue to ensure that the claim cap does not become a claim trap. Congressional and judicial action should be taken to resolve this inequity to landlords. Until that happens, commercial landlords should consider the steps they can take when drafting and negotiating their commercial leases to minimize the adverse impact of the cap in the event of a tenant bankruptcy and ensuing lease rejection.

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