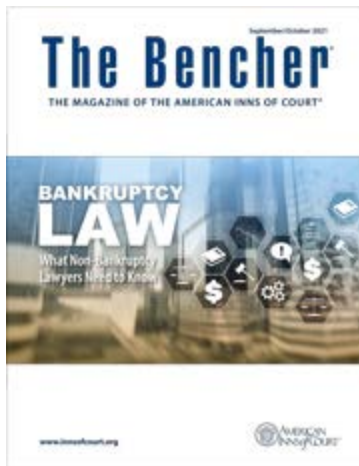


It's the Leased You Can Do—An Overview of §502(b)(6) and Lease Claims

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The headlines scream it! “Retail Tenants Leverage Pandemic Stress for Rent Cuts” (*Wall Street Journal*, January 11, 2021). “Malls’ Decline Pushes Landlords CBL, PREIT to Bankruptcy” (*Wall Street Journal*, November 2, 2020).

Debtors, as lessees, rejecting leases is now an everyday occurrence, and the impact on the lessors is varied. If an accommodation is not reached, then rejection of the lease may well occur, leaving the lessor with a claim in the debtor’s bankruptcy case. How much is the claim? How is it calculated? How do state law and bankruptcy interact?

Bankruptcy Code Section 502(b)(6) provides a statutory cap for allowed claims resulting from “damages resulting from the termination of a lease of real property” in which the debtor is the lessee.

The purpose of the lessor’s cap is “to compensate the landlord for his loss while not permitting a claim so large...as to prevent other general unsecured creditors from recovering a dividend from the estate.”

H.R.Rep. No. 95-595, at 353-54 (1977). While an admirable idea, the calculation of the claim may revive nightmares of high school algebra class.

In this article, I will not address issues such as damages for post-petition rejection of an assumed lease, administrative expense claims for rent, stub rent, triple net leases, and other exhilarating topics. Instead, I will focus on the fundamentals of applying §502(b)(6) and a hopefully easily understood sample calculation.

First, we must define the phrase “claim...for damages resulting from the termination of a lease.” There is a split of authority about what this phrase means and what damages incurred by the lessor are included in the capped calculation. Some courts interpret this term broadly, holding a debtor’s rejection of a lease under §365(a) results in a breach of all covenants in the lease. Therefore, all damage claims by the lessor including, for example, covenants requiring the debtor to maintain and repair the premises are subject to the cap of §502(b)(6). *In re Foamex Int’l, Inc.*, 368 B.R. 383 (Bankr. D.Del. 2007); *In re Mr. Gatti’s, Inc.*, 162 B.R. 1004 (Bankr. W.D.Tex. 1994).

The narrower interpretation applies §502(b)(6) “to solely those damages arising as a consequence of the lease being terminated” but does not apply to non-rejection tort damages such as waste, destruction,

or removal of leasehold property.

The initial calculation in the preamble to §502(b)(6) is the amount of “the claim of a lessor for damages resulting from the termination of a lease of real property.” This requires calculating the uncapped damages recoverable under applicable non-bankruptcy law resulting from termination of the lease by the debtor. The amount of the claim under §502(b)(6) must then be calculated based on the earlier of the dates set forth in §502(b)(6)(A)(i) and (ii). A comparison is then made to the greater of the amount of the rent for one year or 15% (not to exceed three years) of the remaining term of such lease plus any unpaid rent due under such lease, without acceleration. *In re Shane Co.*, 464 B.R. 32, 40 (Bankr. D. Colo. 2012); *In re Iron–Oak Supply Corp.*, 169 B.R. 414, 419 n. 8 (Bankr. E.D. Cal.1994); 2 Norton Bankr. L. & Prac. 3d § 46:49 (“[A] \$5,000 per month lease is rejected five years prior to the end of the lease term. One-year’s rent would be \$60,000 (12 months times \$5,000)....Fifteen percent of the remaining term would be \$45,000 (five years times \$60,000 per year times 15%), a sum which does not exceed three years’ rent (\$180,000). Thus, the landlord’s claim would be the greater of the two, or \$60,000. If the remaining term of the lease was 10 years, the landlord’s claim would be 15% of \$600,000 (10 years times \$60,000 per year), or \$90,000.”).

The court compares those capped amounts in §502(b)(6)(A) and (B) to one another and compares the greater of these two figures to the total non-capped damages under applicable non-bankruptcy law. If non-capped damages are *less* than the greater of the amounts in §502(b)(6)(A) and (B), then the lessor is entitled to the non-capped damages. If total non-capped damages are *greater* than the greater of the amounts set by §502(b)(6)(A) and (B) (which is usually the case), the cap applies, and the lessor is only entitled to the greater of the capped amounts in §502(b)(6)(A) and (B). Don’t despair; the chart below should bring clarity, so read on.

To start the calculations, the date of the termination of the lease must be determined. The rejection of an unassumed lease constitutes a breach immediately before the date of the bankruptcy petition, even if the rejection occurs after the date of the bankruptcy petition. Therefore, the lessor’s has a pre-petition claim for damages resulting from the breach of the lease. §365(g)(1); §502(g)(1). The date from which the calculation begins is the date of the filing of the bankruptcy petition unless there is an earlier surrender or repossession of the property. Most courts look to state law to determine whether the leased property has been surrendered or repossessed.

The term “15 percent, not to exceed three years, of the remaining term of such lease ...” has been debated by courts. Some courts hold the 15% refers to the time left on the lease. Other courts hold the 15% refers to the amount left owing under the lease. If the rent changes over time, some courts following the time method hold “it is necessary to calculate the rent that would accrue in the absence of lease termination to the first 15% of the remaining term, here 14.21 months. Any escalators that would take effect during those 14.21 months are to be honored.” In other words, if the lease obligation increases only after 15% of the remaining lease term has passed, the calculation is based on the lower amount.

Any security deposit, even a letter of credit, should be applied to reduce the capped amount.

Any credit from the lessor’s mitigation of damages by reletting the premises or other means is applied to the *non-cap* termination damages to be calculated for comparison purposes with the cap calculations of §502(b)(6)(A) and (B) and does *not* reduce the *capped* amounts in §502(b)(6)(A) and (B) that are already limited by statute.

Attorney’s fees resulting from termination of the lease may be included in the *non-cap* termination damages to be calculated for comparison purposes with the cap calculations of §502(b)(6)(A) and (B). Attorney’s fees resulting from termination of the lease are included in the amounts to be capped by §502(b)(6)(A) and (B) and are *not* added to the capped amounts *after* calculation to increase the lessor’s claim. Attorney’s fees resulting from events not related to termination of the lease are not limited by §502(b)(6), as those damages are not within the scope of §502(b)(6).

With respect to future rent or some types of deferred rent, § 502(b)(6)(B) permits a lessor to claim, without limitation, the entire amount of rent *already due and owing* under the lease as of the *earlier* of the bankruptcy petition date, or the date the lessor repossessed, or the tenant surrendered, the property. A claim for *future rent* under the lease is capped by §502(b)(6)(A) and may not be included beyond the statutory limit.

Surely that is enough groundwork. Now for our hypothetical lease and calculation of damages. Our example is a 120-month lease with rent due on the first of the month at \$3,000 per month with a total rent of \$360,000 and a security deposit of \$6,000. The debtor paid for 12 months but is past due for the 13th month and files bankruptcy prior to the rent payment due for the 14th month on April 1, 2021. The debtor immediately moves to reject the lease and surrenders possession on March 31, 2021. Below are the calculations under §502(b)(6) for this simple example.

1. All damages incurred by lessor resulting from termination of lease, <i>excluding damages not related to termination of the lease.</i> 108 mos. x \$3,0000	\$324,000
2. Date of petition	March
3. Date lessor repossessed property or tenant surrendered property (<i>i.e., pre-petition repossession or surrender date</i>).	March
4. Earlier of dates in 2 & 3 or petition date <i>unless</i> there was a pre-petition repossession or surrender date.	March
5. Amount equal to one year of rent (without acceleration) from date listed in 4.	\$36,000
6. Amount equal to 15% of rent not to exceed three years (without acceleration) from date listed in 4. Time method: 108 mos. x .15 = 16.20 x \$3,000 = \$48,600. Amount method 108 mos. x \$3,000 = \$324,000 x .15 = \$48,600	\$48,600
7. Greater of 5 or 6	\$48,600
8. Amount of unpaid rent (without acceleration) from date listed in 4. Excludes <i>future</i> rent.	\$3,000
9. Deductions such as security deposit, etc.	\$6,000
Total of claim under §502(b)(6) which is <i>lesser</i> of 1 or total of 7+8-9	\$45,600

Well, there you are—not as painful as high school algebra and hopefully more helpful. If only real-life leases and the calculations were this easy, but at least this may help some of us understand the basics.

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