Bankruptcy, a Landlord's Perspective
Part 2: The Landlord's Claim if the Lease is Rejected
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An understanding of the limitations on a landlord's claim in the event a tenant rejects its lease after filing bankruptcy provides the practitioner the ability to counsel its client during lease negotiations and after the bankruptcy filing to maximize the recovery by the landlord. This article will discuss those limitations and suggests alternative sources of recovery of the landlord's damages.

The Cap on Damages – 11 U.S.C. § 502(b)(6)

Upon notice from the tenant of its rejection of the lease, the landlord must file a proof of claim to preserve its claim against the bankruptcy estate.[1] The rejection of the lease is deemed a breach of the contract which gives rise to a claim for damages as an unsecured creditor. *In re Miller*, 282 F.3d 874 (6th Cir. 2002).

The damages which may be recovered by a landlord for future damages is limited by 11 U.S.C. § 502(b)(6), which provides that future damages are limited to the greater of one year's "rent reserved" or 15 percent of the total "rent reserved" remaining for the duration of the lease up a maximum of three years.

However, the landlord's damages for pre-petition rent is not capped and, in addition, the landlord should file an administrative expense claim for the amount of post-petition rent until the date of rejection.[2]

Calculating Damages

Actual Damages

When analyzing the maximum allowable claim under 502(b)(6), the practitioner should remember that the section is only a cap and if actual damages are less than the cap, then the section does not apply.

Furthermore, the practitioner should also caution the landlord that Florida law requires that a landlord use reasonable efforts to mitigate damages. If a landlord finds a replacement tenant, any rent the landlord receives from the new tenant will be deducted from the landlord's actual damages before application of the cap. If the landlord re-leases the premises immediately after rejection at or above the debtor's lease payment amount, then the landlord has not sustained any future damages and does not have a claim under 502(b)(6).

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[1] The debtor must receive permission from the bankruptcy court to reject the lease. The order authorizing the rejection may also include a deadline to file a proof of claim for rejection damages. If no deadline is stated in the order, the landlord must file a proof of claim by the claims bar date.

[2] As noted in Part 1, the debtor must continue to pay post-petition rent until it rejects, assumes or assigns the lease. 11 U.S.C. § 365(d)(3).

Another consideration is whether the lease includes a paragraph defining actual damages if the lease is terminated. If the lease does not define actual damages, the damages are calculated pursuant to state law.

The Cap Amount

The next question is whether the actual damages exceed the statutory maximum. This inquiry requires that the practitioner first determine what is the rent reserved. Clearly a monthly fixed rental amount is "rent reserved", but leases often include rent based on a percentage of gross sales, payments for taxes, insurance, common area maintenance, attorney's fees and other items that make it difficult to distinguish rent and non-rent charges. In determining whether a charge is rent, courts have looked at whether the charge is designated as "rent" or "additional rent", whether the charge is related to the value of the property or value of the lease and whether the charge is fixed, regular or periodic. *In re McSheridan*, 184 B.R. 91 (B.A.P. 9th Cir. 1995); *In re New Valley Corp.*, 2000 WL 1251858 (Distr. N.J. Aug. 31, 2000); *In re Blatstein*, 1997 WL 560119 (E.D. Pa. 1997). After determining what to include in "rent reserved", the practitioner must then calculate the statutory maximum damages.

If actual damages (taking into account mitigation) are greater than the total under the statutory formula, then the landlord's claim is the limited to the statutory maximum. Where the landlord's rejection damages are less than the cap, then the damages will be allowed without limitation.

Security Deposits

A landlord cannot avoid the Section 502(b)(6) cap by taking a large security deposit at the inception of the lease. Bankruptcy Courts have held that a security deposit held by a landlord must be applied against the landlord's maximum claim under 502(b)(6). *In re Handy Andy Home Improvement Centers, Inc.*, 222 B.R. 571 (Bankr. N.D. Ill. 1998); *In re PPI Enterprises, Inc.*, 228 B.R. 339 (Bankr. D. Del. 1998).

In the alternative, the landlord should consider obtaining a third party(s) guarantee of the lease. The third party guarantee's liability should be not affected by the bankruptcy and would, for example, provide another source of funds for the landlord in the event the security deposit was insufficient to reimburse the landlord for the full value of its damages in the event of the tenant's bankruptcy and the estate did not pay the unsecured claim in full or if the statutory cap cut-off the landlord's ability to collect its actual damages from the tenant.

Protecting the landlord in a tenant's bankruptcy is not a simple mathematical calculation. The practitioner must have a complete understanding of the Bankruptcy Code's limits on damages in order to counsel the landlord and take action to preserve the landlord's claim against the bankruptcy estate.

Next Month: Part 3: The Landlord's Rights if the Lease is Assigned or Assumed

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