Court Adopts 'Time' Approach in Applying Section 502(b)(6) Cap

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U.S. Bankruptcy Judge Kevin J. Carey of the District of Delaware's recent opinion in *In re Filene's Basement LLC*, Case No. 11-13511 (KJC), has provided long-awaited guidance on the application of Section 502(b)(6) of the Bankruptcy Code to lease rejection damages claims in the bankruptcy context. Perhaps most significantly, the court concluded that the "15 percent" referred to in Section 502(b)(6)(A) of the Bankruptcy Code refers to the remaining term of the lease, rather than the remaining rent due thereunder. The *Filene's* opinion marks the first time that the Delaware bankruptcy court has addressed this issue, an issue that has been the subject of a split in authority amongst other jurisdictions. Additionally, the court adopted an instructive approach for determining whether certain additional landlord claims should be subject to the cap contained in Section 502(b)(6)(A).

Filene's Basement LLC, as tenant, and Connecticut/DeSales LLC, as landlord, were successors-in-interest under a retail lease for nonresidential real property located in Washington, D.C. The lease was entered into Oct. 7, 1986, and provided for an original lease term of 20 years, with four options to renew for additional terms of 10 years. On March 10, 2010, Filene's entered into an amendment to the lease whereby it exercised the first option and extended the lease term through Jan. 31, 2019. On Nov. 2, 2011, Filene's and certain affiliated entities (collectively, the debtors) commenced cases under Chapter 11 of the Bankruptcy Code. Pursuant to lease rejection procedures approved by the bankruptcy court, Filene's rejected the lease pursuant to Section 365 of the Bankruptcy Code effective as of Dec. 31, 2011. The landlord then timely filed a rejection damages claim, which was subsequently amended, seeking (1) an administrative claim for post-petition November 2011 rent; (2) a rejection damages claim for reserved rent, including base rent, operating expense reimbursement and other related obligations under the lease, which it purported to cap under Section 502(b)(6) of the Bankruptcy Code; and (3) additional claims relating to the removal of abandoned furniture and fixtures and the removal of a mechanic's lien on the premises, which the landlord did not limit under Section 502(b)(6) of the Bankruptcy Code. The debtors subsequently filed an objection to the claim on the basis that the landlord failed to properly apply Section 502(b)(6) of the Bankruptcy Code.

Section 502(b)(6) of the Bankruptcy Code provides, in pertinent part, that a claim by a lessor for damages resulting from the termination of a lease of real property shall be disallowed to the extent that such claim exceeds "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 (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered the leased property." The landlord attempted to apply Section 502(b)(6) by determining the total base rent and other "rent" amounts due for the remaining term of the lease and multiplying that total by 15 percent. The debtors, on the other hand, argued that the statutory reference to "15 percent" was intended to be a measure of time remaining under the lease term (with such period of time not to exceed three years), rather than a reference to the remaining rent due for the term of the lease.

While courts in other jurisdictions are divided over the proper interpretation of Section 502(b)(6) of the Bankruptcy Code, the issue has not previously been addressed by the U.S. Court of Appeals for the Third Circuit. Consistent with Third Circuit precedent on statutory interpretation, the bankruptcy court first looked to whether the intent of Congress was clear on its face (i.e., whether the terms of the statute are unambiguous). In doing so, the bankruptcy court concluded that a natural reading of the statutory language of Section 502(b)(6) supported the "time" approach for calculating the landlord's claim. While noting that the plain meaning of Section 502(b)(6) should end its inquiry, the bankruptcy court continued to note that the legislative history and policy behind capping a landlord's claim for lease termination damages also supported the "time" approach.

The bankruptcy court next looked to whether the Section 502(b)(6) cap should also apply to the landlord's claims for removing abandoned furniture and fixtures and removing a mechanic's lien resulting from the debtors' failure to pay a service contractor. The initial inquiry as to whether Section 502(b)(6) applied to these claims was whether such claims were "for damages resulting from the termination of a lease of real property." The bankruptcy court held that the abandonment claim did fall within the scope of Section 502(b)(6), in that it constituted damages resulting from the termination of the lease. The court, however, noted that this was not the end of its inquiry in determining whether amounts should be included in the calculation of a landlord's claim under Section 502(b)(6). Indeed, the court noted that once it determines that a claim is for lease termination damages, it must then decide whether the claim may be included as part of what is "rent reserved" under Section 502(b)(6)(A). In making this determination, the court stated that the charge must be (1) designated as "rent" or "additional rent" in the lease or be provided as the tenant's/lessee's obligation in the lease; (2) related to the value of the property or the lease thereon; and (3) properly classifiable as rent because it is a fixed, regular and periodic charge. The court ultimately held that the abandonment claim did not qualify as "rent reserved," as such amount was not a fixed, regular or periodic charge under the lease. In analyzing the mechanic's lien claim, the court concluded that the mechanic's lien claim existed independent of whether the lease was terminated, and was not caused by the termination of the lease. As such, the Section 502(b)(6) cap did not apply to this claim.

Given the split in authority that exists amongst other jurisdictions, a great deal of uncertainty has existed in Delaware as to the proper interpretation of Section 502(b)(6)(A). The court's *Filene's* decision has resolved this dispute in favor of the "time" approach, while providing helpful guidance as to whether additional landlord claims may be subject to the limitations set forth in Section 502(b)(6) of the Bankruptcy Code.

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