

KICKEM & TELLUS

MEMORANDUM

TO: Harry Hardnose
FROM: Kickem & Tellus
DATE: February 18, 2006
RE: Lease Rejections and the Calculation of Damages upon Rejection

Introduction

After a debtor files for relief under chapter 11 of the Bankruptcy Code, it may reject leases which are burdensome or otherwise unnecessary to the debtor's reorganization efforts. Section 365(a) of the Bankruptcy Code provides "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. 11 U.S.C. § 365(a). Accordingly, in order to reject a lease, section 365(a) of the Bankruptcy Code requires the Company to file a motion seeking Bankruptcy Court permission to reject these leases and must give interested parties notice of the motion and an opportunity to object.

Removal of Property from Premises

To ensure that the debtor-tenant does not incur any further costs related to rejecting a lease, the debtor should understand the potential repercussions of failing to remove its property from the premises of a lease it intends to reject. The Bankruptcy Court may decide that by leaving property on the leased premises, the debtor-tenant has failed to surrender the premises, and that the lease should therefore not be rejected. Even if the court approves rejection of the lease, the landlord may be able to recover administrative costs for holding the debtor-tenant's property on the leased premises. Finally, the landlord may seek damages for removal and disposition of debtor-tenant's property.

The debtor-tenant's failure to remove its property from the leased premises may, in some states, delay the rejection of the lease. Section 365(a) of the Bankruptcy Code provides "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. 11 U.S.C. § 365(a). Some courts have interpreted this section to mean that rejection is effective when the landlord receives and accepts unequivocal notice of the debtor's intent to reject, and that rejection may occur prior to issuance of the order approving rejection. Under this view, debtor may reject a lease prior to obtaining a court order authorizing the rejection. To do so, the debtor must comply with the law of the state in which the leased premises are located governing lease termination.

Surrender of Premises

Under state law, a surrender of the leased premises is often required. A surrender can be express or by operation of law. An express surrender requires the landlord to explicitly communicate his or her assent to the surrender. A surrender by operation of law occurs through some act of the landlord so inconsistent with the relation of landlord and tenant and incompatible

with the existing terms of the lease as to imply the parties agreed to a surrender. Courts have held that the burden of proof is on the party alleging the surrender by operation of law to prove it, and, where it is to be inferred from the circumstances or conduct inconsistent with intention to perform, the proof must be clear. Furthermore, the intention of the parties must be clearly expressed, such as a writing declaring the parties' intentions. By failing to remove its property, the debtor-tenant raises the possibility that a court will construe a landlord's repossession for reasons other than accepting the debtor-tenant's surrender of the premises.

If the court finds that the debtor-tenant's and the landlord's actions have not effectuated a rejection, then, under Section 365(d)(3) of the Bankruptcy Code, the debtor-tenant remains responsible for any rent that accrues post-petition until the lease is rejected. Under the 2005 amendments to the Bankruptcy Code, section 365(d)(4) of the Bankruptcy Code does serve to automatically reject leases that have not been rejected or assumed within the earlier of (i) 120 days of the filing of the petition for bankruptcy and (ii) the date of entry of an order confirming a plan.

Calculation of Rejection Damages

Once a non-residential real property lease is rejected, Section 502(b)(6) of the Bankruptcy Code limits lease rejection damages:

(6) if such a claim is that of a landlord for damages resulting from termination of a lease, the claim will be capped at the sum of:

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or fifteen 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 the landlord repossessed, or the tenant surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

* * *

11 U.S.C. § 502(b)(6).

Section 502(b)(6) provides a cap on a landlord's unsecured claim for lease termination, not a formula for determining such claim. The formula for determining the landlord's claim itself is derived from state law. Therefore, it is necessary to first determine the maximum amount of a landlord's damage claim under state law without regard to the damages cap. In determining this amount, a court will consider the landlord's duty - by contract or by operation of law - to mitigate its damages for the debtor-tenant's rejection of the lease. The mitigation duty serves to reduce a landlord's total unsecured claim in the bankruptcy. Mitigation is considered *before* the application of the damages cap. If the landlord's claim, as mitigated, remains greater than the maximum allowable claim under § 502(b)(6), the damages cap still applies. However, if because of mitigation factors a landlord's claim is less than the maximum allowable claim under § 502(b)(6), the damages cap has no application and the landlord's

maximum allowable claim is limited to its state law claim as mitigated. Once the court has determined the landlord's damage claim under state law, the court must then identify those damages subject to the damages cap.

The damages cap applies to a "claim for damages resulting from the termination of a lease". 11 U.S.C. § 502(b)(6). In most instances, the damages cap applies only to those damages that the landlord would have avoided but for rejection of the lease, such as future rent, as well as costs reasonably and necessarily incurred in attempting to relet the premises, such as attorneys fees, brokerage fees, taxes, and the like. However, the damages cap does not include expenses for long-term capital improvements where such improvements serve more to benefit the landlord than to restore the premises. Moreover, the damages cap would exclude damages for the breach of a covenant, unrelated to the lease termination, such as failure to repair and maintain the premises in accordance with the lease.