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Column
Last in Line

*36 COPING WITH REJECTION §502(B)(6)--THE EVOLVING LAW OF LEASE REJECTION DAMAGES

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As the number of retail bankruptcies continues to rise, the law of lease rejection damages has become increasingly important. For every retailer who files bankruptcy and sheds unprofitable stores via lease rejection, there are legions of landlords and lawyers who must turn to §502(b)(6) of the Bankruptcy Code in order to determine the amount of the landlord's allowed unsecured claim for lease rejection damages. [1]

Unfortunately, §502(b)(6) is "not a model of drafting clarity." *In re Gantos*, 176 B.R. 793, 796 (Bankr. W.D. Mich. 1995); *In re Vause*, 886 F.2d 794, 801 (6th Cir. 1989). The confusing wording of §502(b)(6) has spawned a body of case law which interprets nearly every phrase of the statute. In order to correctly determine the landlord's allowed claim for lease rejection damages, the landlord and the lawyer must understand the case law which has evolved construing § 502(b)(6).

Section 502(b)(6) states, in pertinent part:
(b) ...if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount except to the extent that -

(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds -

(A) 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; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;
Even a cursory reading of this statute raises several questions. This article reviews the case law that has evolved to answer the frequently asked questions.

Is §502(b)(6) a Formula or a Cap?

The cases uniformly hold that §502(b)(6) is a cap on the landlord's allowed claim for lease rejection damages-*not* a formula for their calculation. *In re Gantos*, 176 B.R. 793, 795 (Bankr. W.D. Mich. 1995); *In re Goldblatt*, 66 B.R. 337, 345 (Bankr. N.D. Ill. 1986). Indeed, the Bankruptcy Code does not contain a formula for calculation of the landlord's lease rejection damage claim. Therefore, courts instruct landlords to look to state law and to the lease to calculate the actual damages for lease rejection. *See In re Financial News Network*, 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993). The landlord should then determine whether those damages exceed the statutory limit imposed by §502(b)(6); if so, the landlord's allowed unsecured claim for lease rejection damages will be limited to the amount authorized by the Bankruptcy Code's statutory cap in § 502(b)(6). *See In re Q-Masters*, 135 B.R. 157, 159 (Bankr. S.D. Fla. 1991).

Although §502(b)(6) is drafted as a cap, a careful reading of its subsections reveals that only the landlord's claim for *future* lease rejection damages is capped by §502(b)(6)(A); there is no cap on the landlord's claim for past rent, *see* §502(b)(6)(B).

When Does the Cap Apply?

Courts are split on the issue of whether the cap in §502(b)(6) applies to all types of the landlord's damage, or whether the landlord can have additional claims. Some courts hold that §502(b)(6) caps all damages that arise from the tenant's rejection of the lease and the resultant non-performance of the tenant's obligations thereunder. *See In re Storage Technology*, 77 B.R. 824, 825 (Bankr. D. Col. 1986); *In re McSheridan*, 184 B.R. 91, 102 (9th Cir. B.A.P. 1995). Consistent with this approach, the statutory cap of §502(b)(6) has been applied even where the debtor's assets were sufficient to pay all creditors' claims and the landlord's claim in full. *See In re Federated Department Stores*, 131 B.R. 808 (S.D. Ohio 1991).

Other courts have held that §502(b)(6) caps *only* the damages that the landlord would have avoided if the tenant had not rejected the lease. *See, e.g., In re Atlantic Container*, 133 B.R. 980, 987-988 (Bankr. N.D. Ill. 1991); *In re Farley*, 146 B.R. 739, 746 (Bankr. N.D. Ill. 1992); *In re Bob's Sea Ray Boats*, 143 B.R. 229, 231 (Bankr. D.N.D. 1992). In *Atlantic*, 133 B.R. at 987, the court noted that §502(b)(6)(A) governs *future* damages and makes them subject to the statutory cap, but past damages are governed by § 502(b)(6)(B), which allows them in full. In *Bob's Sea Ray*, 143 B.R. at 231, the court endorsed *Atlantic*, then ruled that §502(b)(6) does not cap the landlord's damages which are collateral to lease rejection, such as waste, destruction or removal of leasehold property. Similarly, in *Farley*, 146 B.R. at 746, the court concluded that the landlord's damages from the tenant's alleged conversion of property and non-payment of taxes before lease rejection were *not* subject to the statutory cap in §502(b)(6).

Still another approach was enunciated in *In re International Coins*, 18 B.R. 335, 338 (Bankr. D.Vt. 1982). That court held that §502(b)(6) only caps rent, and therefore a claim for damage to the leased premises was not subject to the statutory cap.

Defining "Rent Reserved"

The meaning of "rent reserved" is the most frequently litigated issue under § 502(b)(6). "Rent reserved" has often been defined as "the consideration paid for use or occupation of the property." Most courts agree that "rent reserved" must have some relationship to the value of the property and the value of the lease thereon. *See, e.g., In re McSheridan*, 184 B.R. 91, 97 (9th Cir. B.A.P. 1995). Therefore, rent, real estate taxes, insurance premiums and common area maintenance charges have been found to be "rent reserved" under § 502(b)(6)(A). *See, e.g., In re Heck's*, 123 B.R. 544, 546 (Bankr. S.D.W.Va. 1991); *In re Goldblatt Bros.*, 66 B.R. 337, 345 (Bankr. N.D. Ill. 1986). In *In re Farley*, 146 B.R. 739, 747 (Bankr. N.D. Ill. 1992), a yearly capital improvement fee was also included in "rent reserved." Conversely, attorney's fees, general maintenance charges, janitorial expenses, electrical repairs, charges for new signs and keys and the like are commonly *excluded* from "rent reserved" because they relate to the *use* of the property, rather than the value of the property or of the lease. *See, e.g.,* *37 *In re Storage Technology*, 77 B.R. 824, 825 (Bankr. D. Colo. 1986); *Heck's, supra; Farley, supra; Goldblatt, supra.* Utility charges are problematic and some courts include them in "rent reserved" while other courts do not. (*Compare In re Conston*, 130 B.R. 449, 455 (Bankr. E.D. Pa. 1991) *In re Heck's*, 123 B.R. 544, 546 (Bankr. S.D. W.Va. 1991)).

Several courts have devised guidelines to determine whether a particular item is included or excluded from "rent reserved" under §502(b)(6). In *In re Conston*, 130 B.R. 449, 455 (Bankr. E.D. Pa. 1991) the court held that appendages to "pure" rent were allowable as "rent reserved" only if the lease expressly so provides and the items in question are regular, fixed, periodic charges payable in the same way as "pure" rent. However, the court in *In re Rose's Stores*, 179 B.R. 789, 791 (Bankr. E.D.N.C. 1995) expressly rejected the *Conston* tests of "rent reserved" and, instead, held that "rent reserved" includes only those items that are the tenant's obligations under the lease (even if they are not denominated "rent"), and related to the value of the property and the value of the lease thereon. Applying these criteria, *Rose's* held that taxes, insurance, and a mandatory minimum charge to maintain the property were included in the "rent reserved," but that the utilities and tenant's general maintenance responsibility were not "rent reserved" for purposes of § 502(b)(6).

Recently, the 9th Circuit Bankruptcy Appellate Panel enunciated a three-part test for determination of "rent reserved":

1. The item must be designated as "rent" or "additional rent" in the lease *or* be provided as a tenant's obligation in the lease, and

2. The item must relate to the value of the property or the lease thereon, and

3. The item must be properly classifiable as "rent" because it is a fixed, regular, or periodic charge. *In re McSheridan*, 184 B.R. 91, 99-100 (9th Cir. B.A.P. 1995).

Where Does 15% Apply?

The reference to "15 percent, not to exceed three years, of the remaining term of such lease" in §502(b)(6)(A) is particularly cryptic. Does "15 percent" quantify the time left on the lease or the amount of rent reserved for the balance of the lease term. The fact that the "15 percent" quantifier appears just before the phrase "not to exceed three years" in §502(b)(6)(A) helps fuel the controversy and highlights the ambiguity of this statute.

If the rent is constant throughout the lease term, it will likely make no difference whether the phrase "15 percent" refers to time or rent. However, if the rent increases over the lease term, the application of "15 percent" to rent, as opposed to time, will affect the outcome of the landlord's claim calculation for lease rejection damages.

The majority view is that "15 percent" refers to rent (*i.e.*, money), not time. *See, e.g., In re Gantos*, 176 B.R. 793, 796 (Bankr. W.D. Mich. 1995); *In re McLean Enterprises*, 105 B.R. 928 (Bankr. W.D. Mo. 1989); *In re Communicall Cent.*, 106 B.R. 540 (Bankr. N.D. Ill. 1989); *In re Q-Masters*, 135 B.R. 157 (Bankr. S.D. Fla. 1991); *In re Bob's Sea Ray Boats*, 143 B.R. 229 (Bankr. D.N.D. 1992); *In re Financial News Network*, 149 B.R. 348 (Bankr. S.D.N.Y. 1993). The minority view applies the "15 percent" to time by multiplying the time remaining on the lease by 15 percent. *See, e.g., In re Iron-Oak Supply*, 169 B.R. 414 (Bankr. E.D. Ca. 1994). Proponents of this minority view believe that the structure of §502, which speaks generally in terms of *time* periods for which rent is due, supports their interpretation of § 502(b)(6)(A). *See In re Allegheny International*, 145 B.R. 823 (W.D. Pa. 1992).

Post-petition Rent

Once the debtor/tenant rejects the lease, the landlord may find a new tenant to fill the space. This raises the issue of whether the landlord must subtract the rent received from the new tenant ("mitigating rent") from the landlord's lease rejection damage claim against the debtor/former tenant. When calculating the landlord's lease rejection damage claim under §502(b)(6), the real issue becomes whether the mitigating rent is to be deducted from the landlord's gross and actual claim for lease rejection damages (*i.e., before* application of the statutory cap contained in §502(b)(6)), or against the landlord's statutorily-capped claim for lease rejection damages under § 502(b)(6).

Most courts have held that the mitigating rent should be deducted from the gross and actual amount of the landlord's lease rejection damage claim computed in accordance with state law, but should *not* be deducted from the landlord's statutorily-capped claim for lease rejection damages under §502(b)(6). These courts note that the statutory cap embodied in §502(b)(6) already imposes a serious reduction on the landlord's actual claim for lease rejection damages and it would be unfair to further reduce that net amount by the mitigating rent. *Compare, e.g., In re All for a Dollar,* 28 BCD 584 (Bankr. D. Mass. 1996); *In re Financial News Network,* 149 B.R. 348, 350-353 (Bankr. S.D.N.Y. 1993); *In re Bob's Sea Ray Boats,* 143 B.R. 229, 231 (Bankr. D.N.D. 1992); *In re Atlantic Container,* 133 B.R. 980, 989-90 (Bankr. N.D. Ill. 1991); *In re Conston,* 130 B.R. 449, 451-454 (Bankr. E.D. Pa. 1991); *In re McLean Enterprises,* 105 B.R. 928, 937 (Bankr. W.D. Mo. 1989); and *In re Goldblatt Brothers,* 66 B.R. at 346-348 with *Stewart's Properties,* 41 B.R. 353-355 (Bankr. D. Hawaii 1984).

When Does Rent Become "Due"?

In *In re Vause,* 886 F.2d 794 (6th Cir. 1989) the United States Court of Appeals for the 6th Circuit rejected the debtor's interpretation that pre-petition rent payable in arrears was not "due" as of the bankruptcy filing date because the debtor had no obligation to make the payment until four days after the bankruptcy petition was filed. Instead, the court used a "plain meaning" analysis and interpreted the word "due" to mean "owing." This interpretation prevented the debtors, who had the use of the land for 361 days, from receiving a windfall based on the fortuity of their bankruptcy filing date. In reaching its conclusion, the Court of Appeals noted that §502(b)(6) was "intended to compensate landlords for their *actual damages* while placing a limit on large future, speculative damages which would displace other creditors' claims." 886 F.2d at 802.

Conclusion

As the old adage goes, "even a broken clock is right twice a day." Although §502(b)(6) is poorly drafted and hard to understand, the case law that has evolved to interpret it has, in fact, answered many of the most commonly asked questions.

While the Bankruptcy Code strives for equal treatment among all similarly situated creditors, and therefore requires all landlords to resort to § 502(b)(6) to determine the allowed amount of their lease rejection claims, this article demonstrates that the practical application of §502(b)(6) often yields unequal results. This is not a failing in §502(b)(6) of the Bankruptcy Code, but merely a predictable consequence of its structure which requires landlords to look to the lease and to state law for the *formula* for calculation of the landlord's actual damage claim for lease rejection. The problem is exacerbated by the differing statutory interpretations enunciated by the courts.

In reality, each lease is unique and each claim for lease rejection damages will be unique. This uniqueness makes it hard to craft any statute that applies equally to all landlords in all rejected leases. Perhaps this is the real problem we have coping with lease rejection damages under §502(b)(6).

Footnotes

1 The landlord's lease rejection damage claim is an unsecured claim by virtue of 11 U.S.C. §365(g).

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