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CALCULATING A LANDLORD'S CLAIM IN BANKRUPTCY

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Unlike most unsecured creditors, a landlord's claim is limited in a bankruptcy proceeding. The purpose of the limitation is to allow landlords whose tenant rejects the lease a claim without disproportionately affecting all other claims.' While there is a specific provision regarding landlord damages arising from a lease rejection, the Bankruptcy Code leaves open how exactly to calculate the claim. This article explores some of the issues that have arisen in connection with the calculation of landlord claims.

SECTION 502(b)(6)

Section 502(b)(6) of the Bankruptcy Code limits a commercial landlord's claim for lease rejection damages, by disallowing such a claim to the extent that it 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**
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> **(i) the date of the filing of the petition; and**
>
> **(ii) the date on which such lessor repossessed, or the lessee surrendered, the lease property plus**

See In re Highland Superstore's, Inc., 154 F.3d 573, 577, 33 Bankr. Ct. Dec. (CRR) 157, 40 Collier Bankr. Cas. 2d (MB) 1038, Bankr. L. Rep. (CCH) ¶ 77785, 1998 FED App. 0265P (6th Cir. 1998) (Congress intended to compensate landlords for actual damages while limiting large, future, speculative damages that would displace other creditors' claims).

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

In other words, a landlord has a claim for the greater of one year's rent or fifteen percent of the remaining term of the lease, not to exceed three years. For example, if the remaining term is 6 years, the landlord will have a claim for one year's rent (which is greater than 15% of the remaining term). If the remaining term of the lease is 30 years, 15% would be 4.5 years. Accordingly, the claim would be capped at 3 years.

Section 502(b)(6) is not a formula for determining allowable damages.' Rather, Section 502(b)(6) casts a limitation on a lessor's claim for unpaid rent.' First the amount of the claim must be ascertained,' then the limitation is applied. If a landlord has no claim for remaining rent, Section 502(b)(6) does not grant that landlord any additional claim. In *In re Highland Superstores, Inc.,"* the court discussed a four-step process courts usually go through to determine a landlord's rejection claim. The court calculates the total rents due under the lease from the earlier of the petition date or the date the premises were repossessed; then the court determines whether 15% of the rent is higher than one year's rent; if it is higher, the 15% is compared to three years rent under the lease; finally, on the basis of these calculations, the court determines the amount of damages.

Under Code § 502(b)(6), as part of its lease rejection claim, a landlord may only assert a claim for "future rent" damages, as limited by § 502(b)(6)(A), and a claim for prepetition "unpaid rent" under § 502(b)(6)(B). The first question that courts have considered is what constitutes "rent."

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[2] 11 U.S.C.A. § 502(b)(6).

[3] In re Fifth Ave. Jewelers, Inc., 203 B.R. 372, 376, 30 Bankr. Ct. Dec. (CRR) 65, 37 Collier Bankr. Cas. 2d (MB) 273 (Bankr. W.D. Pa. 1996).

[4] *Id.*

[5] Although the Bankruptcy Code is silent on this point, several courts have determined that the amount of rent due over the lease term must be reduced to present value. *See, e.g., Highlands Superstores,* supra note 1, 154 F.3d at 577 (both parties agreed that future rents should be discounted to present value). *See also* In re Ames Dept. Stores, Inc., 209 B.R. 627, 631 (S.D. N.Y. 1997) (reduce landlord's claims to present worth); In re Child World, Inc., 161 B.R. 349, 352, 24 Bankr. Ct. Dec. (CRR) 1450 (Bankr. S.D. N.Y. 1993) (general rule is that measure of damages which landlord may recover as a result of tenant's rejection of lease is the difference between rental value of remainder of term and rent reserved, both discounted to present worth.)

[6] *Highlands Superstores,* supra note 1, 154 F.3d at 577.

RENT UNDER SECTION 502(b)(6)

In *In re McSheridan*,[7] the Ninth Circuit Bankruptcy Appellate Panel articulated a standard for determining what obligation constitutes "rent" that has been accepted by several courts. In *McSheridan*, considering pre-petition rent, the Ninth Circuit BAP established a three-part test to determine whether a particular charge under a lease qualified as "rent reserved," such that it could be included in the "future rent" components under section 502(b)(6):

(1) The charge must be (i) designated as "rent" or "additional rent" in the lease; or (ii) denominated as the tenant/lessee's obligation in the lease;

(2) The charge must be related to value of the property or the lease thereon; and

(3) The charge must be properly classified as rent because it is a fixed, regular, or periodic charge.'

The *McSheridan* court's three-part test is premised on the common-law understanding of what constitutes "rent."[9]

The *McSheridan* court further held that "rejection of the lease results in the breach of each and every provision of the lease, including covenants, and § 502(b)(6) is intended to limit the lessor's damages resulting from that rejection. Accordingly, under *McSheridan*, a landlord has a single claim for lease termination damages, measured by § 502(b)(6) of the Bankruptcy Code. The rationale in *McSheridan* has been followed by some courts."

While *McSheridan* discussed rent in the context of Code § 502(b)(6)(A), other courts have extended *McSheridan* to apply to

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[7] In re McSheridan, 184 B.R. 91, 27 Bankr. Ct. Dec. (CRR) 585, 33 Collier Bankr. Cas. 2d (MB) 1300, Bankr. L. Rep. (CCH) If 76614 (B.A.P. 9th Cir. 1995).

[8] *Id.*, 184 B.R. at 99-100.

[9] *Id.* at 97.

[10] *Id.* at 102.

[11] *See* In re Pacific Arts Pub., Inc., 198 B.R. 319, 323-24, 29 Bankr. Ct. Dec. (CRR) 394, 36 Collier Bankr. Cas. 2d (MB) 406 (Bankr. C.D. Cal. 1996) (disallowing a landlord's claim that did not meet the *McSheridan* test). *See also* In re PPI Enterprises (U.S.), Inc., 228 B.R. 339, 348, 33 Bankr. Ct. Dec. (CRR) 856 (Bankr. D. Del. 1998) (applying the *McSheridan* test to determine that attorney's fees were not rent under § 502(b)(6)).

the term "rent" in § 502(b)(6)(B). For example, in *In re Smith*, the court noted that: "Although the B.A.P. [in *McSheridan]* was solely concerned with § 502(b)(6)(A), this test has been applied to claims under § 502(b)(6)(B).''

In *Smith,* the court held that an unamortized building allowance, which required a landlord to contribute up to $28,500 toward construction work, failed to meet all of the elements of the *McSheridan* test. With respect to the second prong of the *McSheridan* test, the *Smith* court stated: "[a]bsent default, Landlord had no expectation of recouping any part of the $28,500.00, so the building allowance cannot be related to the value of the property or the Lease.' [14]

On the other hand, in *In re Q-Masters, Inc.,"* the court addressed § 502(b)(6)(B) and allowed the landlord's claim for property damage as part of the rent owed under § 502(b)(6)(B). Likewise, in *In re Clements,"* the bankruptcy court was "persuaded that all sums due under the lease at the time of the filing of the petition should be included as part of [the landlord's] claim." Under § 502(b)(6)(B), the court included and allowed legal expenses, taxes, insurance and maintenance expenses."

Several other courts have not limited claims for damages arising prior to the filing of the petition. For example in *In re Bob 's Sea Ray Boats, Inc.,"* the landlord filed a claim, including a portion for damages to the property. The court agreed with other courts that had held that § 502(b)(6) applies only to the time period following termination. Section 502(b)(6) "does not address damages wholly collateral to the termination event—such things as waste, destruction or removal of leasehold property. The court held that the damages asserted by the landlord had nothing to do with the kind of damages restricted by § 502(b)(6), and allowed the claim.

In re Smith, 249 B.R. 328, 337, 36 Bankr. Ct. Dec. (CRR) 57, 44 Collier Bankr. Cas. 2d (MB) 443, Bankr. L. Rep. (CCH) ¶ 78204 (Bankr. S.D. Ga. 2000).

[13] *1d.,* 249 B.R. at 339.

Id.

In re Q-Masters, Inc., 135 B.R. 157, 160 (Bankr. S.D. Fla. 1991).

In re Clements, 185 B.R. 895, 903 (Bankr. M.D. Fla. 1995).

[17] *1d.*

In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 230, 27 Collier Bankr. Cas. 2d (MB) 656 (Bankr. D. N.D. 1992).

[19] 1d., 143 B.R. at 231.

[20] 1d.

In *In re Best Products Co., Inc.,*" the landlord filed a claim including deferred maintenance damages. After an extensive review of the history of § 502(b)(6) and several decisions, including *In re Mr. Gatti's, Inc.*, and *McSheridan,* the court concluded that any damages caused by the debtor's failure to maintain the premises was unrelated to the lease termination, and therefore were not restricted by § 502(b)(6).[23] The court disagreed with courts holding that § 502(b)(6) limits damages resulting from rejection to all damages resulting from nonperformance of the tenant's obligations under the lease. "The rulings of the bankruptcy courts in *Mr. Gatti's* and *McSheridan,* while not unreasonable, strike me as resting upon a somewhat tortured analysis of the relevant code sections.''[25]

In fact, the *Best Products* court concluded that most cases do not follow the restrictive rationale of *Mr. Gatti's* and *McSheridan.* "Rather, the weight of authority in reported opinions where landlords have actually claimed damages for such items as maintenance and repairs is that these damages do *not* result 'from the termination of a lease of real property' and are therefore not subject to the cap of § 502(b)(6)(A).''[26] The court allowed the claim for deferred maintenance damages, finding that any damages caused by the debtor's failure to fulfill its repair and maintenance obligations were unrelated to the lease termination 2[7]

The *Best Products* court cited with approval the analysis applied in *In re Atlantic Container Corp.* In that case, the landlord sought to recover, inter alia, for repair and maintenance expenses required to remedy physical damage caused by the debtor's failure to perform necessary maintenance. The court concluded that maintenance damages were not the type of damages contemplated in the phrase

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In re Best Products Co., Inc., 229 B.R. 673, 674 (Bankr. E.D. Va. 1998).

In re Mr. Gatti's, Inc., 162 B.R. 1004 (Bankr. W.D. Tex. 1994).

Best Products, supra note 21, 229 B.R. at 679.

Id. at 677.

[25] *1d.* at 677-78.

Id. at 678 (emphasis in original; citations omitted).

Id at 679.

In re Atlantic Container Corp., 133 B.R. 980, 22 Bankr. Ct. Dec. (CRR) 521, 26 Collier Bankr. Cas. 2d (MB) 597, Bankr. L. Rep. (CCH) ¶ 74388 (Bankr. N.D. Ill. 1991).

[29] 1d., 133 B.R. at 983.

"damages resulting from the termination of a lease.''[30] "Any damages caused to the Premises by the Debtor's failure to fulfill its repair and maintenance obligations are unrelated to the termination of the lease."[31] The goal is to avoid a debtor's liability under a long-term lease. However, the court concluded that the maintenance damages had nothing to do with the long-term nature of the leases.

As can be seen, there is a split between courts regarding the definition of "rent" for purposes of calculating a landlord's rejection claims. Some courts construe "rent" narrowly, while others allow the inclusion of collateral charges like repair and maintenance costs.

HOW TO CALCULATE 15% OF THE REMAINING TERM OF THE LEASE

Another question that has arisen in calculating a landlord's claim is whether 15% of the "remaining term" of the lease under Bankruptcy Code § 502(b)(6) is 15% of the dollar amount of rent remaining to be paid, or 15% of the time remaining under the lease. In *In re Andover Togs, Inc.*,[33] the court commented that the view that the phrase "remaining term" refers to the rent remaining to be paid under the lease is the majority view. After an extensive review of the analysis provided by other courts, the *Andover* court concurred 'that a landlord's claim is determined by calculating 15% of the rent remaining to be paid. Similarly, in *In re Gantos, Inc.*,[35] the court opined that the majority of case law supports the position that the § 502(b)(6) damage cap is a function of rent, not time. The court. rejected the debtor's claim that 15% refers to time remaining under the lease, and held that it was reasonable for the landlord to receive damages for the rent for which the parties had bargained.

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[30] *Id.* at 987.

[31] *Id.*

[32] *1d*

[33] In re Andover Togs, Inc., 231 B.R. 521, 545 (Bankr. S.D. N.Y. 1999).

[34] *1d.* at 547.

[35] In re Gantos, Inc., 176 B.R. 793, 796, 26 Bankr. Ct. Dec. (CRR) 662, Bankr. L. Rep. (CCH) ¶ 76437 (Bankr. W.D. Mich. 1995).

[36] *See also* In re Financial News Network, Inc., 149 B.R. 348, 351, 23 Bankr. Ct. Dec. (CRR) 1431, 28 Collier Bankr. Cas. 2d (MB) 384, Bankr. L. Rep. (CCH) If 75115 (Bankr. S.D. N.Y. 1993) (concurring with landlord's calculation of 15% of total rents).

On the other hand, in *In re Allegheny Intl, Inc.*,[37] the court based the landlord's damages on 15% of the time remaining under the lease, rather than the amount of rent reserved. Affirming the bankruptcy court, the district court noted that 15% means time because the statute references time periods when discussing damages limitations. Similarly, in *In re Iron-Oak Supply Corp.*,[39] the court concluded that Congress meant the phrase "remaining term" to be a measure of time, not rent.

MITIGATION

Whether or not a landlord whose tenant is in bankruptcy has a duty to mitigate damages also remains an open issue. Some states do not require a commercial landlord to mitigate damages upon a tenant's default.

Under Virginia law, if a tenant abandons the premises prior to expiration of the lease, the landlord is not required to relet the premises for the tenant's benefit. Notwithstanding the foregoing, some courts have concluded that, once a tenant is in bankruptcy, a landlord must attempt to mitigate its damages.

Duty to Mitigate

In ***In re Handy Andy Home Improvement Centers, Inc.***,[42] the court commented that a landlord has a duty to mitigate, citing ***In re Bob's***

In re Allegheny Intern., Inc., 136 B.R. 396, 17 U.C.C. Rep. Serv. 2d 459 (Bankr. W.D. Pa. 1991), decision aff'd and remanded, 145 B.R. 823 (W.D. Pa. 1992).

Id., 136 B.R. at 403.

In re Iron-Oak Supply Corp., 169 B.R. 414, 420, 25 Bankr. Ct. Dec. (CRR) 1269, 31 Collier Bankr. Cas. 2d (MB) 439, Bankr. L. Rep. (CCH) ¶ 76009 (Bankr. E.D. Cal. 1994).

See, e.g., Holy Properties Ltd., L.P. v. Kenneth Cole Productions, Inc., 87 N.Y.2d 130, 637 N.Y.S.2d 964, 966, 661 N.E.2d 694 (1995); Cummings Properties, LLC v. Empire Technologies, Inc., 2002 Mass. App. Div. 84, 2002 WL 971807 at *2 (2002) (commercial landlord need not mitigate when tenant elects to vacate).

Crowder v. Virginian Bank of Commerce, 127 Va. 299, 103 S.E. 578, 579 (1920). *See also* tenBraak v. Waffle Shops, Inc., 542 F.2d 919, 924 (4th Cir. 1976) (upon tenant's abandonment, landlord is entitled to remaining rents that accrue under the lease).

In re Handy Andy Home Imp. Centers, Inc., 222 B.R. 571, 575, (Bankr. N.D. Ill. 1998).

Sea Ray Boats, Inc." Neither of these courts explained the basis for finding a duty to mitigate, nor do the decisions explain whether the courts were applying state law related to mitigation. Similarly, in *D.H. Overmyer Co., Inc. (Ohio) v. Irving Trust Co.*,[44] notwithstanding the fact that New York law does not impose a duty to mitigate, the district court rejected application of New York law on the issue of mitigation, stating "[the landlord's] claim that the bankruptcy court should have applied New York law on the subject of mitigating damages is rejected."

In *Matter of Parkview-Gem, Inc.,"* the district court actually applied the common law of both Missouri and Tennessee, noting that the law "appears to be that a landlord has no duty to mitigate his damages when a tenant defaults on a lease." Applying Missouri law, the court held that if a landlord treats a default as a lease termination, the landlord then has a duty to mitigate.

No Duty to Mitigate

Other courts have applied state law in determining whether or not a duty to mitigate exists. In ***In re*** *Andover Togs, Inc.,"* the court applied New York law to conclude that the landlord "has no duty under its commercial lease with Andover to mitigate its damages."

In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231, 27 Collier Bankr. Cas. 2d (MB) 656 (Bankr. D. N.D. 1992) ("As with any claim for damages arising out of the breach of a lease, a claim for damages under section 502(b)(6) is subject to mitigation including an obligation on the part of the landlord to attempt the re-letting of the premises.").

D.H. Overmyer Co., Inc. (Ohio) v. Irving Trust Co., 60 B.R. 391, 394 n. 5 (S.D. N.Y. 1986).

Matter of Parkview-Gem, Inc., 465 F. Supp. 629, 636 (W.D. Mo. 1979).

[46] *1d See also* In re Lomax, 194 B.R. 862, 865, 28 Bankr. Ct. Dec. (CRR) 1282, 35 Collier Bankr. Cas. 2d (MB) 1172, Bankr. L. Rep. (CCH) ¶ 76973 (B.A.P. 9th Cir. 1996) (applying California law related to landlord's duty to mitigate); *Highland Superstores,* supra note 1, 154 F.3d at 577 (landlord has duty to mitigate damages).

Andover Togs, supra note 33, 231 B.R. at 543.

See also In re Episode USA, Inc., 202 B.R. 691, 695 37 Collier Bankr. Cas. 2d (MB) 172 (Bankr. S.D. N.Y. 1996), as amended, (Nov. 20, 1996) (applying New York law in rejecting landlord's duty to mitigate); In re PAVCO Enterprises, Inc., 172 B.R. 114, 117 (Bankr. M.D. Fla. 1994) (applying Florida mitigation law); In re Ames Dept. Stores, Inc., 158 B.R. 35, 36 (Bankr. S.D. N.Y. 1993) (commercial landlord has no duty to mitigate); In re Blond-

In *In re Episode USA*, the court concluded that a chapter 11 debtor-guarantor could not assert a mitigation defense, because New York law did not recognize a duty to mitigate after breach of a commercial lease. Bankruptcy Judge Garrity's reasoning consisted of a single statement: "In any event, New York does not recognize a duty to mitigate damages by reletting premises after breach of a commercial lease."[51] In support, the court cited two New York state court decisions, and another decision from the bankruptcy court for the Southern District of New York.

CONCLUSION

The Bankruptcy Code provides no guidance as to how a landlord's claim should be calculated. Additionally, the case law is inconsistent regarding the calculation of a landlord's claims. Depending on the jurisdiction, a claim may be measured by the dollar amount remaining under the lease, rather than the time remaining. Also, some courts will require a landlord to mitigate, while others will allow a claim regardless of mitigation efforts. Finally, some jurisdictions will include expenses and fees as rent, while other courts take a much more restrictive view.

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heim Modular Mfg., Inc., 65 B.R. 856, 861 (Bankr. D. N.H. 1986) (applying New Hampshire mitigation law).

[51] *Episode USA*, supra note 48.

[52] *Id.*, 202 B.R. at 697.