

Real Estate Law journal

A WEST PUBLICATION

SUMMER 2004

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DOES THE GUARANTOR OF A REAL PROPERTY LEASE ENJOY THE PROTECTION OF SECTION 502(b)(6) OF THE BANKRUPTCY CODE?

MICHAEL J. LICHTENSTEIN

While Congress has granted landlords some specific protections under the Bankruptcy Code, Congress has also imposed limitations on a landlord's claim in a bankruptcy proceeding. The purpose of the limitation is to allow a landlord whose tenant rejects the lease a claim without disproportionately affecting all other claims.¹ Some courts have ruled that a debtor/guarantor of a lease enjoys the same protection and is liable only up to the amount of the limited claim under the Bankruptcy Code. On the other hand, courts have not extended the same protection to nondebtor guarantors.

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
 - (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

¹See *In re Highland Superstars, Inc.*, 154 F.3d 573, 577 (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.'

Accordingly, a landlord can claim 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 were 30 years, 15% would be 4.5 years. Accordingly, the claim would be capped at 3 years.

The purpose of the section 502(b)(6) limitation is to permit a landlord to recover without denying other unsecured creditors any opportunity for recovery. Congress was concerned that a landlord with a long term lease, holding a twenty or thirty year claim, could devour the debtor's estate to the point where only crumbs would be left for the other creditors.' In *In re Lindsey*,² the court agreed that the purpose of the section 502(b)(6) limitation "is to preclude landlords from obtaining disproportionately large claims based upon long-term leases." In *In re Episode USA, Inc.*,³ the court suggested that the section 502(b)(6) limitation is like a liquidated damages provision. The landlord retains possession of the premises and does not get the lion's share of the estate to the detriment of the other unsecured creditors.'

The issue discussed in this article is whether guarantors of a lease are entitled to the same protection limiting a landlord's claim. The answer has generally depended on whether or not the lease guarantor is also a debtor.

Debtor/guarantors

In *In re Episode*,⁴ the debtor had guaranteed a non-debtor affiliate's performance under a non-residential real property lease. The debtor asserted that, even though it was a guarantor rather than

² 11 U.S.C. § 502(b)(6).

³ *In re Episode USA, Inc.*, 202 B.R. 691 (Bankr. S.D. N.Y. 1996).

⁴ *In re Klein Sleep Product, Inc.*, 78 F.3d 18, 20 (2d Cir. 1996).

⁵ *In re Lindsey*, 199 B.R. 580, 585 (E.D. Va. 1996), **aff'd** in part, vacated on other grounds in part, 1997 WL 705435 (4th Cir. 1997).

⁶ 202 B.R. at 694.

⁷ *Id.*

⁸ *Id.* at 692.

a lessee, the Bankruptcy Code capped the landlord's claim.⁹ The landlord claimed that section 502(b)(6) is ambiguous and applies only if the debtor is the lessee.¹⁰ In its review, the court noted that, on its face, the statute neither includes nor excludes guarantors from its **application**." The thrust of the statute is not to a particular debtor-entity; rather, the statute acts to limit a landlord's recovery from bankruptcy estate assets.¹ In light of the debtor's insolvent status, the court concluded that capping the landlord's claim would not contravene the drafters' intentions." Accordingly, the court sustained the debtor's objection to the landlord's claim."

In *In re Thompson*,¹⁵ the court considered confirmation of a Chapter 13 plan where the landlord had objected, asserting a full claim **based** on the debtor's guaranty. The debtor acknowledged liability but asserted that the claim should have been limited under section **502(b)(6)**." The court noted that allowance in full of a landlord's claim would be **inappropriate** because other creditors would suffer a disproportionate loss." The court was persuaded by the logic articulated in *In re Rodman*¹⁶ that permitting a landlord's claim to consume a substantial part of the property would be unfair because a landlord has the opportunity to mitigate his damages by **reletting** the property." In that case, the landlord had been compensated up to the date the bankruptcy petition was filed and also reacquired the property.¹ Following this logic, the *Thompson* court

⁹Id. at 694.

¹⁰Id.

"Id. at 695.

¹²
Id.

¹ Id.

Id. at 697. See also *In re Southern Cinemas, Inc.*, 256 B.R. 520, 534 (Bankr. M.D. Fla. 2000) (case law indicates strongly that cap applies to **guarantors** of leases in bankruptcy, as well as lessees); *In re Clements*, 185 B.R. 895, 901 (Bankr. M.D. Fla. 1995) (case law has firmly established that Section 502(b)(6) applies to **guarantors** of leases in bankruptcy).

¹⁵ 116 B.R. 610, 611 (Bankr. S.D. Ohio 1990).

Id.

"Id. at 613.

¹⁸60 B.R. 334 (Bankr. W.D. Okla. 1986).

In re Thompson, 116 B.R. at 613.

In re Rodman, 60 B.R. 334 (Bankr. W.D. Okla. 1986).

limited the landlord's claim against the guarantor debtor under section **502(b)(6)**.²¹

The Ninth Circuit has also held that the section 502(b)(6) cap applies to debtor/guarantors. In *re Arden*²² involved a dispute between the debtor/guarantor and the landlord over the breach of a long-term lease. The bankruptcy court confirmed a plan, based on the finding that the section 502(b)(6) limitation did not apply to the landlord **claim**.²³ The Ninth Circuit Bankruptcy Appellate Panel reversed and the Ninth Circuit affirmed the BAP, agreeing that the landlord's claim should have been **limited**.²⁴ The Ninth Circuit pointed out that the claim of the lessor, not the status of the lessee or its guarantor, triggers the application of section **502(b)(6)**.²⁵ This was clearly a lessor's claim for damages resulting from a lease **termination**.²⁶ "Because the cap snugly fits, the court should have donned it."²⁷ The Ninth Circuit concluded that applying the section 502(b)(6) cap would achieve a Congressional desire to limit landlords' otherwise disproportionately large **claims**.²⁸ Because the landlord's claim was substantial, the Ninth Circuit determined that one could not conclude that Congress obviously intended the landlord's claim should be subject to the cap."

In *In re Interco*,²⁹ the debtor objected to proofs of claim arising out of the rejection of real property leases. The debtor argued the section 502(b)(6) clearly applies to lease **guarantors**.³⁰ The landlord argued that the Bankruptcy Code limits only a claim against a tenant, not against a **guarantor**.³¹ This Court noted that, on its face, the statute neither includes nor excludes guarantors from the **cap**.³² The statute limits landlord's recovery from a bankruptcy estate after

²¹ *In re Thompson*, 116 B.R. at 613.

²² 176 F.3d 1226, 1227 (9th Cir. 1999).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 1229.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ 137 B.R. 1003, 1005 (Bankr. E.D. Mo. 1992).

³¹ *Id.* at 1005.

³² *Id.*

³³ *Id.*

lease **rejection**. The result is to limit a landlord's damages, not to limit the liability of a particular entity." Therefore, a literal application of the statute would result in the limitation of a landlord's recovery regardless of the entity that is the debtor.' The **court** noted that the policy behind section 502(b)(6) is to compensate the landlord fairly while protecting other creditors in a **bankruptcy**.³⁷ "This rationale is applicable whether the debtor is the tenant or the guarantor of the lease." The court concluded that a literal reading of the statute limited the lessors' damages."

One bankruptcy court, *In re Danrik, Ltd.*,⁴⁰ has concluded that the section 502(b)(6) cap did not apply to a **debtor/guarantor**. The debtor objected to the claim filed by a landlord on a guaranty of a commercial lease! The landlord argued that the cap does not apply to a solvent **guarantor**." The debtor filed a plan that proposed to pay **unsecured** creditors in full.' In light of this, the court concluded that the equities did not compel limiting the guaranty claim." The landlord's claim would not consume the estate and the other creditors had been paid in **full**.⁴⁵ In reviewing the legislative history of section 502(b)(6), the *Danrik* court noted that purpose is to limit **damages** allowable to a debtor's landlord." The legislative history does not mention a limitation of damages allowable to a lease **guarantor**.⁴⁷

Reviewing the history of the Bankruptcy Act, the court suggested that originally the limitation was designed to help landlords who

Id.

Id.

Id.

Id. at 1006.

Id.

Id. See also *In re McSheridan*, 184 B.R. 91 (B.A.P. 9th Cir. 1995).

⁴⁰92 B.R. 964 (Ban/cr. N.D. Ga. 1988).

⁴¹Id. at 965.

⁴²Id.

⁴³Id. at 967.

Id. at 967.

Id.

Id.

Id.

previously had no provable claim for **rent**. In 1934, Congress adopted amendments that allowed landlords a limited claim and thereby helped **them**.⁴ Reviewing cases cited by the debtor in support of limiting the guarantor's claim, the court noted that the decisions were based upon the equities of the cases, not the statutory **language**. However, the *Danrik* case involved unusual facts that led the court to conclude that it would be unfair to limit the guarantor's claim by applying section 502(b)(6).⁵ Because the other creditors had been paid in full, there would be no prejudice if the guarantor's claim were allowed in **full**. The court also concluded that it would be "unfair and inconsistent with any statutory purpose" to treat the guaranty claim any worse than it would be treated outside of bankruptcy." Finally, the court suggested it would be **difficult** to calculate a section 502(b)(6) claim when the lessee had never filed for bankruptcy." Section 502(b)(6) references the "earlier of the filing of the petition" and the date the landlord repossessed or the "lessee surrendered the leased property." The only logical reading of the statute is that it refers to the lessee's petition, not the petition of a **guarantor/debtor**. In light of the fact that there was a solvent guarantor/debtor where all the creditors had been paid, the lessee had not filed for bankruptcy, and the claim was not disproportionately large, the court ruled that the section 502(b)(6) limitation did not apply to the landlord's claim."

Non-debtor guarantors

In *In re Modern Textile, Inc.*,⁵⁸ the defendants argued that the trustee's rejection of the lease terminated the debtor's obligations

⁴⁹ **Id.** at 968.

Id.

Id. at 970.

Id.

Id. at 971.

⁵³ **Id.**

Id.

Id. citing 11 U.S.C.A. § 502(b)(6).

Id. at 972.

⁵⁷ **Id.**

⁵⁸

900 F.2d 1184, 1191 (8th Cir. 1990). It is worth noting that the Eighth Circuit pointed out the Section 502(b)(6) issue had not been raised to the trial court but the Eighth Circuit ruled on the issue anyway.

and thereby discharged their guaranty, at least in any amount in excess of the claim against the estate. The Eighth Circuit disagreed and held that a guarantor is not subject to section 502(b)(6).⁵⁹ After the debtor's rejection of the lease, the landlord's claim for amount in excess of the amount chargeable to the estate was not extinguished.⁶⁰ The Eighth Circuit found support for this conclusion in section 524(e) of the Bankruptcy Code, which states, the "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such **debt**. In light of the foregoing, the Eighth Circuit wrote: "We therefore conclude that the Trustee's rejection of the Clarksville sublease did not discharge the defendant's **guaranty** of Buyer's lease obligations as a matter of **law**."⁶²

*Bel-Ken Associates Limited Partnership v. Clark*⁶³ involved a contract claim against the guarantors of a lease where the lessee was in **bankruptcy**. The district court noted that the Bankruptcy Code is designed to benefit and protect **debtors**.⁶⁴ The court rejected the argument that the section 502(b)(6) cap should also limit the liability of third party guarantors." The court cited 11 U.S.C. § 524(e) which specifically limits a discharge of a debtor and does not affect the liability of any other entity for such **debt**. Accordingly, a guarantor's liability remains even if a bankrupt principal is released from **liability**. The court also concluded that holding a guarantor liable was consistent with Maryland law that holds a guaranty as an obligation collected to and independent from the principal **contract**. Finally, "Common sense dictates that the guarantor remain fully li-

⁵⁹Id.

⁶⁰Id.

⁶¹Id., citing 11 U.S.C.A. § 524(e).

⁶²Id. at 1192. See also *Cromwell Field Assoc. L.P. v. May Dept. Stores Co.*, 5 Fed. Appx. 186, 189 (4th Cir. 2001) (unpublished) (agreeing with *Modern Textile* that lessor can look to guarantor for full amount).

⁶³83 B.R. 357 (D. Md. 1988).

"Id. at 358.

⁶⁴Id.

"Id.

⁶⁷Id.

⁶⁸Id.

able even when the principal debtor seeks relief under the Bankruptcy Code.”⁶⁹

CONCLUSION

The Bankruptcy Code does not specify whether the limitation set forth in section 502(b)(6) against landlord claims applies to the claims of lease guarantors. Courts have applied the limitation to debtor/guarantors in order to protect other creditors from a disproportionately large landlord claim. However, when the guarantor has been a non-debtor, courts have not extended the same protection. The basis for this distinction arises in section 524(e) of the Bankruptcy Code, which limits a discharge to a debtor and does not affect third party liabilities.

Id. at 359. See also *River Oaks L.P. v. Things Remembered, Inc.*, 1993 WL 147409, *2 (N.D. Ill., May 3, 1993) (citing to *Modern Textile* and *Bel-Ken* with approval).