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By Scott A. Wolfson

The recent wave of retail bankruptcies, and the store closings they have left in their wake, has many landlords on unfamiliar turf: the bankruptcy court. Not only is the turf unfamiliar, it is unfriendly. The Bankruptcy Code's[1] provisions governing landlord claims are poorly written and sharply limit the damages a landlord can claim when a debtor-tenant terminates its lease. In addition, the landlord's capped claim will be paid in bankruptcy dollars, likely to be mere pennies on the dollar. Therefore, an understanding of the Bankruptcy Code's limitations on a landlord's lease rejection damages is important to properly counsel landlords at lease inception, in the shadow of a tenant bankruptcy, and in the bankruptcy itself, to maximize the landlord's recovery from the bankruptcy estate.

This article summarizes the law relevant to filing a landlord's claim in the bankruptcy of a debtor-tenant that has rejected its lease.

iphering the Damage Cap

Filing the landlord's claim in bankruptcy

Lease Rejection

A debtor, or trustee on a debtor's behalf, may assume or reject any unexpired real property lease of the debtor.[2] A debtor-tenant's rejection of its lease gives the landlord a claim that the landlord must preserve by filing a proof of claim with the bankruptcy court. When a lease is rejected, it is deemed breached and the landlord has a claim for damages as an unsecured creditor.[3] Any claim arising from the breach is deemed to have arisen before the date the debtor-tenant filed its bankruptcy petition.[4]

Section 502 of the Bankruptcy Code addresses the allowance of claims against a debtor.[5] A landlord's proof of claim, like all proofs of claim filed in a bankruptcy case, is prima facie evidence of the claim's validity and amount,[6] and is deemed allowable unless a party in interest objects.[7] If an objection to a landlord's claim is raised, subsection 502(b)(6), which limits the amount of the landlord's claim for future damages against a debtor-tenant, determines the extent to which the landlord's claim will be allowed by the bankruptcy court.

The Cap—11 USC 502(b)(6)

Section 502(b)(6) of the Bankruptcy Code imposes a limit or cap on the future damages a lessor of real property may claim as a result of a debtor-tenant's lease rejection:

> *(b) [I]f 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;****

Fast Facts:

A landlord's future damages are limited to the greater of one year's rent or 15 percent of the total rent remaining for the duration of the lease up to a maximum of three years.

The cap limits only a landlord's claim for future damages sustained after its tenant files a bankruptcy petition.

Michigan, like most states, requires the landlord to use reasonable efforts to minimize the damages caused by the debtor-tenant's breach of the lease.

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That is, the landlord's future damages are limited to the greater of one year's rent or 15 percent of the total rent remaining for the duration of the lease up to a maximum of three years. The landlord's damages for unpaid pre-petition rent due are not capped.[8]

The purpose of the cap is to compensate a landlord for its loss from a debtor-tenant's rejection of the landlord's lease without giving the landlord such a large damage claim in the case of rejection of a long-term lease that the dividend paid by the debtor-tenant's bankruptcy estate to other creditors would be excessively diluted.[9] The Sixth Circuit Court of Appeals recently expressed this public policy: "Congress intended to compensate landlords for their actual damages while placing a limit on large future, speculative damages, which would displace other creditors' claims."[10]

It is important to note that the cap limits only a landlord's claim for future damages sustained *after* its tenant files a bankruptcy petition. While these post-petition damages are limited, the damages the landlord incurred up to the earlier of the date of the petition filing and the date of repossession or lease surrender are not.[11] In sum, the landlord receives actual past damages, and limited future damages.[12]

Calculating the Damage Claim

Actual Damages

Section 502(b)(6) simply limits the amount of damages a landlord may claim in a debtor-tenant's bankruptcy and is premised on the existence of a damage claim of the landlord. It is not a formula for calculating the landlord's damages.[13] If the landlord's aggregate actual damages from debtor-tenant's lease rejection are less than the amount allowed by the cap, Section 502(b)(6) does not apply. Therefore, the first step in calculating the landlord's claim is to calculate the actual damages to determine if they are subject to the statutory cap.

Courts uniformly hold that a landlord's damages are to be computed in accordance with the lease terms and applicable state law, and are then limited by application of Section 502(b)(6).[14] Whether a landlord has properly mitigated its damages must be determined by referring to state law.[15] Michigan, like most states, requires the landlord to use reasonable efforts to minimize the damages caused by the debtor-tenant's breach of the lease.[16]

Any rent a landlord receives from a replacement tenant will be deducted from the landlord's actual damages before application of the cap.[17] If the landlord succeeds in mitigating its damages and immediately upon lease rejection re-leases the premises at an equal or higher rent than the debtor-tenant was paying, the landlord generally will not have a Section 502(b)(6)(A) claim for future damages.[18] Most landlords will not be so lucky, and will be forced to dive into the murky language of Section 502(b)(6) to determine the amount of their claim.

Capping the Damage Claim

Once the landlord's actual damages are calculated under state law, the next question is whether these damages exceed the damages

the landlord may claim under Section 502 (b)(6). The sixth circuit in *In re Highland Superstores, Inc* outlined a four-step process for applying Section 502(b)(6) to determine the landlord's allowable claim in the tenant's bankruptcy:

- The court calculates the total rent due under the remaining lease term from the earlier of the date of filing or the date on which the landlord repossessed or the tenant surrendered the leased property.
- The court determines whether 15 percent of that total is greater than the rent reserved for one year following the debtor's filing.
- The 15 percent amount is compared to the rent reserved under the applicable lease for three years following filing.
- The court, on the basis of the foregoing calculations, arrives at the total allowable amount of the landlord's rejection damages, which is the greater of one year's rent or 15 percent of the total remaining rent (up to a maximum of three years), plus any unpaid pre-petition rent.[19]

"Rent Reserved"

Section 502(b)(6)'s one year versus 15 percent comparison is based on "the *rent reserved* by such lease, without acceleration...."[20] While a fixed monthly payment over the course of a lease is clearly "rent reserved," today's sophisticated leasing arrangements often include rent based on a percentage of the tenant's gross sales, and payments by the tenant for taxes, insurance, common area maintenance, attorney's fees, janitorial services, and other items that may blur the distinction between rent and non-rent charges.

A bankruptcy court will typically require the following for a charge to qualify as "rent reserved" under the lease. First, the charge must be expressly designated as "rent" or "additional rent" in the lease or be designated as the tenant's obligation in the lease. In addition, the charge must be related to the value of the property or to the value of the lease on the property. Finally, the charge also must be properly classifiable as rent; it must be a fixed, regular, or periodic charge.[21]

Example Damage Cap Calculation

An example helps to illustrate the cap's application. Tenant BrokeCo. leased property from a landlord for a five-year term at a monthly rental of $10,000. BrokeCo. filed for bankruptcy at the end of the first year, immediately rejected the lease, then abandoned the premises. BrokeCo. owed two months rent ($20,000) when it filed for bankruptcy.

The first step is to determine the landlord's actual damages under the lease and state law to determine if the cap will limit those damages. Assume that, despite the landlord's commercially reasonable attempts to re-lease the property, the landlord has been unable to find a replacement tenant. The remaining term of this five-year lease is four years, or 48 months, at $10,000 per month, totaling $480,000 in future damages. Adding the $20,000 in unpaid rent to the $480,000 in future damages, the landlord's actual damages under state law total $500,000.

The bankruptcy court puts this $500,000 actual damage claim on the chopping block and ultimately limits it to a $140,000 general unsecured claim. Here is how. The first step under the *Highland Superstores* four-step process is to calculate the "rents reserved" under the remaining lease term from the date tenant filed its bankruptcy petition, which total $480,000 (48 months × $10,000 per month). The second step is to calculate 15 percent of that amount ($480,000 × .15),[22] which is $72,000. That amount is then compared to the rent reserved for one year (12 months × $10,000), which is $120,000. The court will use the greater number, in this case $120,000.

The third step only comes into play when 15 percent of the total rents due under the remainder of the lease term is greater than the rent reserved for one year under the lease, which, when the monthly rent does not change during the lease, will occur only when the remaining lease term exceeds 80 months. If the 15 percent figure is used, the landlord's claim cannot exceed three years of rent. In this case, because the remaining lease term is only 48 months, the one year of rent figure ($120,000) is used, and a comparison to the three year total is unnecessary.

The last step of the *Highland Superstores* process is to calculate the total allowable amount of the landlord's rejection damages, which includes unpaid rent of $20,000 and future rent capped at $120,000, for a total unsecured landlord claim of $140,000.

A sizeable security deposit may ensure that the landlord recovers all or a portion of its capped claim, but any excess security deposit cannot be retained and applied to the landlord's actual damage claim.

The contrast between a landlord's damage claim inside and outside of bankruptcy is stark: $140,000 versus $500,000. Not only is the landlord's damage claim greatly reduced in bankruptcy, but the landlord will likely be paid in "bankruptcy dollars," that is, at a fractional rate per dollar where the debtor-tenant's assets are insufficient to pay unsecured creditors in full after payment of secured creditors and other creditors with priority over unsecured creditors.[23] For example, if unsecured creditors receive a distribution of ten cents on the dollar, landlord will receive a grand total of $14,000, perhaps over time, which will not even compensate the landlord in full for the $20,000 of unpaid rent BrokeCo. owed when it filed for bankruptcy.

Some landlords have begun to require their tenants to post a letter of credit for the landlord's benefit in an attempt to avoid Section 502(b)(6)'s damage cap.

Security Deposits

A landlord cannot avoid the Bankruptcy Code's limitation on post-petition future rent damages simply by taking a large security deposit from a financially suspect tenant. Section 502(b)(6) does not refer to security deposits, but its legislative history makes clear that a security deposit must be applied against a landlord's claim as capped under Section 502(b)(6), not against a landlord's actual damages.[24] Bankruptcy courts have followed this legislative history and it is well-settled that a security deposit held by a landlord on a rejected lease must be applied against the landlord's maximum claim for lease termination damages allowed under Section 502(b)(6).[25]

Further, the House and Senate reports provide that "to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate."[26] Thus, a sizeable security deposit may ensure that the landlord recovers all or a portion of its capped claim, but any excess security deposit cannot be retained and applied to the landlord's actual damage claim.

Some landlords have begun to require their tenants to post a letter of credit for the landlord's benefit in an attempt to avoid Section 502(b)(6)'s damage cap. Whether a landlord can draw on a letter of credit to its fullest extent, regardless of the claim cap under Section 502(b)(6), is an evolving issue, and the few courts that have addressed the question have disagreed.[27] A better solution to protect the landlord is to obtain a third-party's guaranty of the lease because the third-party guarantor's liability should not be affected by the tenant's bankruptcy or Section 502(b)(6).[28]

In the above example, if the landlord held a security deposit from BrokeCo. of $15,000, the landlord would have a secured setoff claim of $15,000 and an unsecured claim of $125,000. If the landlord had coerced a $150,000 security deposit from BrokeCo., landlord's capped claim of $140,000 would be fully secured, but the remaining $10,000 would go to BrokeCo.'s bankruptcy estate, and could not be used by the landlord to offset actual damages that exceed the cap of Section 502(b)(6).

Conclusion

An understanding of the limits on a landlord's damage claim in the event of a tenant bankruptcy is essential to counsel the landlord and properly file and preserve the landlord's claim in the bankruptcy court. ✦

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Footnotes

1. 11 USC 101 et seq.
2. 11 USC 365(a); *Miller v Chateau Communities, Inc (In re Miller),* 282 F3d 874, 876 (CA 6, 2002).
3. See *In re Miller,* 282 F3d at 877.
4. 11 USC 502(g); *In re Miller,* 282 F3d at 878.
5. 11 USC 502.
6. FR Bank P 3001(f).
7. 11 USC 502(a); *Smith v Sprayberry Square Holdings, Inc (In re Smith),* 249 BR 328, 332 (Bankr SD Ga 2000).
8. Section 502(b)(6) also does not limit administrative expense claims by the landlord based upon the debtor-tenant's use of the premises following the filing of a petition. See 4 Alan N. Resnick et al., *Collier on Bankruptcy,* ¶ 502.03[7][g] (15th ed. rev. 2002).
9. See *Unsecured Creditors' Committee of Highland Superstores, Inc v Strobeck Real Estate, Inc (In re Highland Superstores, Inc),* 154 F3d 573, 577 (CA 6, 1998); H.R. Rep. No. 95-595 at 352 (1977); S. Rep. No. 95-989 at 62 (1978).
10. *In re Highland Superstores, Inc,* 154 F3d at 577 (quotation omitted).
11. 11 USC 502(b)(6)(B).
12. *In re Gantos, Inc,* 176 BR 793, 795 (Bankr WD Mich 1995).
13. Id.; *In re Andover Togs, Inc,* 231 BR 521, 545 (Bankr SD NY 1999).
14. *In re Highland Superstores, Inc,* 154 F3d at 579; *In re Gantos, Inc,* 176 BR at 795 (stating that after the lessor computes the value of its claim under applicable nonbankruptcy law, the claim is compared with, and limited by, Section 502(b)(6)); *In re Smith,* 249 BR at 334; *Fifth Avenue Jewelers, Inc v Great East Mall, Inc (In re Fifth Avenue Jewelers, Inc),* 203 BR 372, 376 (Bankr WD Pa 1996).
15. *In re Merry-Go-Round Enterprises,* 241 BR 124, 131 (Bankr D Md 1999).
16. See, e.g., *Shiffer v Board of Ed of Gibraltar School Dist,* 393 Mich 190, 224 NW2d 255 (1974); *Jefferson Development Co v Heritage Cleaners,* 109 Mich App 606, 311 NW2d 426, 428 (1981).
17. *In re Fifth Avenue Jewelers, Inc,* 203 BR at 381 ("[M]itigation shall figure into the calculation of [landlord's] damages prior to application of said cap.").
18. *In re Highland Superstores, Inc,* 154 F3d at 577.
19. See id.
20. 11 USC 506(b)(6)(A) (emphasis added).
21. See *Kuske v McSheridan (In re McSheridan),* 184 BR 91, 99–100 (BAP 9th Cir. 1995); *New Valley Corp v Corporate Property Assocs (In re New Valley Corp),* No. Civ. A. 98-982, 2000 WL 1251858, at *13–14 (D NJ Aug 31, 2000).
22. The majority of courts, including a bankruptcy court in the Western District of Michigan, apply the 15 percent cap to the total amount of rent remaining due, not the total amount of time remaining under the lease. See, e.g., *In re Gantos, Inc,* 176 BR at 796 ("The 15% quantifies the aggregate rent remaining and not the time remaining under the lease."). For an example of courts applying the minority view that the 15 percent cap applies to the time remaining under the lease, see *In re Blatstein,* No. Civ. A. 97-3739, 1997 WL 560119, at *15 (ED Pa Aug 26, 1997) and *In re Iron-Oak Supply Corp,* 169 BR 414, 420 (Bankr ED Ca 1994).
23. See 11 USC 507.
24. See H.R. Rep. No. 95-595 at 352 (1977); S. Rep. No. 95-989 at 62 (1978).
25. See, e.g., *In re Handy Andy Home Improvement Centers, Inc,* 222 BR 571, 574 (Bankr ND Ill 1998); *In re PPI Enterprises, Inc,* 228 BR 339, 350 (Bankr D Del 1998).
26. H.R. Rep. No. 95-595 at 352 (1977); S. Rep. No. 95-989 at 62 (1978).
27. See Berman, Geoffrey L., P. Gilhuly, and S. Roth, *Landlords Use Letters of Credit to Bypass the Claim Cap of Section 502(B)(6),* 20-JAN Am Bankr Inst J 16, 32 (2002).
28. See 11 USC 524(e) ("[D]ischarge of a debt of the debtor does not affect the liability of any other entity on . . . such debt."); *In re Modern Textile, Inc,* 900 F2d 1184, 1191 (CA 8, 1990) [Section 502(b)(6)]; *Bel-Ken Assocs Ltd Partnership v Clark,* 83 BR 357, 358–59 (D Md 1988).