

El Toro Has Debtors Seeing Red

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Over the past two decades, courts have been divided on the issue of whether Section 502(b)(6) caps a landlord's claim for maintenance and repair costs associated with its rejected property lease. In a decision last October, Saddleback Valley Community Church v. El Toro Materials Co. (In re El Toro Materials Co, Inc.), 504 F.3d 978 (9th Cir. 2007), the Ninth Circuit ruled that tort claims against the debtor tenant for collateral damages (i.e. damages unrelated to the loss of rental income) to the property were not subject to the Section 502(b)(6) cap. In so ruling, the Ninth Circuit buttressed the courts that have held the cap to be inapplicable to claims for a tenant's breach of repair and maintenance obligations and cast doubt on the viability of the line of cases that have held otherwise.

I. Introduction – Lease Rejection Claims; Application of Section 502(b)(6)

Under Section 365(a) a debtor is given the right to assume or reject executory contracts and unexpired leases. Rejection of a lease entitles the landlord to assert a claim for damages against the debtor's estate. Under Section 365(g)(1), rejection of a lease results in a breach of the lease as of the day prior to the bankruptcy filing. 11 U.S.C. § 365(g)(1). Depending upon the case, lease rejection claims may be large enough to overwhelm an estate.

As the Ninth Circuit in El Toro correctly noted:

Bankruptcy presents a unique challenge: How should a paucity of resources be allocated to cover a multiplicity of claims? Distributing money to satisfy claims is, in most cases, a zero-sum game: Every dollar given to one creditor is a dollar unavailable to satisfy the debt owed to others. For Paul to be paid in full, Peter must be short-changed. Congress sought to balance the interests of competing creditors through an extensive set of rules organizing, prioritizing and structuring claims against the estate.

El Toro, 504 F.3d at 978. One such rule is set forth in Section 502(b)(6). Section 502(b)(6) was designed to compensate a landlord for the loss suffered upon rejection but at the same time limit the recovery to a reasonable amount that would not prevent other creditors from recovering from the estate. H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 353 (1977), U.S.Code Cong. & Admin.News 1978, pp. 5787, 6309.

Specifically, Section 502(b)(6) permits a court to allow a claim of a landlord for damages resulting from the termination of a lease of real property, except to the extent 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

11 U.S.C. § 502(b)(6).

In many instances, commercial real property leases have numerous nonmonetary covenants. The leases are often triple-net leases. In triple-net leases, the lessee pays taxes and assessments, maintenance and repairs, insurance premiums and utilities; each in accordance with specific lease provisions. When a triple-net lease is rejected, the landlord will typically seek to include in the rejection claim damages from the debtor's breach of the nonmonetary covenants, including the covenant to maintain and repair the leasehold premises. In applying Section 502(b)(6), courts have been split on the issue of whether the cap applies to the landlord's damages resulting from the tenant's breach of its obligation to maintain and repair the premises. Some courts hold that Section 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. Other courts have held that Section 502(b)(6) caps only the damages that the landlord would have avoided if the tenant had not rejected the lease. This split was emphasized when, within a matter of five months, the Delaware Bankruptcy Court, in In re Foamex Int'l, Inc., 368 B.R. 383 (Bankr. D. Del. 2007), and Ninth Circuit, in El Toro, issued conflicting decisions on the topic. While conflicting decisions are not unusual when courts consider the application of Section 502(b)(6), in this instance the Ninth Circuit in El Toro, which was issued subsequent to Foamex, called into question the continued viability of the Ninth Circuit BAP case that Foamex relied upon most heavily.

II. In re Foamex Int'l, Inc., 368 B.R. 383 (Bankr. D. Del. 2007)

In Foamex, the debtors rejected two leases of nonresidential real property, both of which contained provisions relating to maintenance and repair obligations. Thereafter the landlord filed a proof of claim for a general unsecured claim for approximately \$794,000, over \$769,000 of which consisted of repair obligations. The debtors objected to the claim. The debtors argued that that limitation on lease termination damages includes covenants for maintenance and repair and, as a result, any such damages are subject to the Section 502(b)(6) cap. Not surprisingly, the landlord asserted that the repair and maintenance damages should be allowed in the full amount because those damages are unrelated to the termination of leases and, thus, not capped by Section 502(b)(6).

With no controlling decisions on the issue in the Third Circuit, the bankruptcy court conducted a thorough examination of the decisions on both sides of the argument. Before

reviewing the decisions, however, the court began its analysis with a comparison between Section 502(b)(6) Bankruptcy Code and its predecessor, section 63(a)(9) of the Bankruptcy Act.

The relevant difference which the parties address and courts have grappled to explain is but one short phrase that appears in the Act and was not carried forward in the Code. Section 63(a)(9) of the Bankruptcy Act provided:

the claim of a landlord for damages or injury resulting from the rejection of an unexpired lease of real estate *or for damages or indemnity under a covenant contained in such lease* shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next exceeding the date of the surrender of the premises to the landlord or the date of re-entry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued, without acceleration, up to date. (*Emphasis added*).

The words in emphasis do not appear in Section 502(b)(6).

Foamex, 368 B.R. at 387. As the court indicated, interpreting the omission of this phrase from Section 502(b)(6) is the basis upon which the courts have been divided.

A. Debtors' Argument – McSheridan

In support of its argument that the cap applies to lease rejection claims without regard to the type of damages involved, the debtors in Foamex relied heavily upon Kuske v. McSheridan (In re McSheridan), 184 B.R. 91 (B.A.P. 9th Cir. 1995). In that case, the Bankruptcy Appellate Panel of the Ninth Circuit held that damages related to the breach of repair and maintenance covenants in the lease were properly limited by the Section 502(b)(6) cap. In reaching its conclusion, the McSheridan court reviewed both the Bankruptcy Act and Bankruptcy Code:

- Section 63a(9) of the Bankruptcy Act referred to the landlord's claim for damages or injury resulting from rejection, and the Bankruptcy Act provided and the Code still provides that rejection equals breach. See former § 63c and § 365(g). Congress thus clearly intended that a landlord's claim for any damages resulting from the rejection of the lease by the debtor, including any and all damages for breach of any covenants within the lease, was to be computed and allowed within the limits of former § 63a(9). Id. at 101.
- Section 365(d)(3) provides for the performance under the lease by the trustee until the lease is assumed or rejected. Section 365(g) provides that rejection constitutes breach of the lease. Section 502(g) provides that a "claim arising from the rejection, under Section 365 of this title ... shall be allowed under subsection (a), (b) or (c) of this section" as a prepetition

claim. Section 502(b)(6) further provides that a claim of a lessor for damages resulting from the termination of a lease of real property shall be subject to the statutory cap. . . . The distinction between past obligations under the lease and damages "caused" by the termination is incorrect because all damages due to nonperformance are encompassed by the statute. Id. at 101-02.

Given these considerations, and reading the Bankruptcy Code as a whole, the McSheridan court concluded that lease rejection "results in the breach of each and every provision of the lease, including covenants, and Section 502(b)(6) is intended to limit the lessor's damages resulting from that rejection." Id. at 102.

Standing alone, McSheridan provided strong support for the debtors' position in the Foamex case. The persuasiveness of McSheridan, the debtors argued, was bolstered by the Third Circuit's decision in First Bank National Association v. Federal Deposit Insurance Corporation, 79 F.3d 362 (3d Cir. 1996). In First Bank, the Third Circuit, interpreting a statute analogous to Section 502(b)(6), held that the cap on damages arising when a receiver disaffirms a lease applies to all damages, including damages resulting from the failure to perform structural repairs and modify the building to comply with federal laws and regulations, not merely to damages for future rent. Id. at 367. In reaching this conclusion, the Third Circuit relied upon the reasoning in McSheridan. Accordingly, the debtors argued that McSheridan was "persuasive if not controlling precedent" for the bankruptcy court. Foamex, 368 B.R. at 389.

For additional support, the debtors relied upon In re Mr. Gatti's, Inc., 162 B.R. 1004 (Bankr. W.D. Tex. 1994) and In re New Valley Corp., 2000 WL 1251858 (D. N.J. 2000). Mr. Gatti and New Valley provide substantially similar analysis to the analysis contained in McSheridan.

B. Landlord's Argument – Atlantic Container

In response, the landlord in Foamex relied upon In re Atlantic Container Corp., 133 B.R. 980 (Bankr. D. Ill. 1991) and cases that have held that Section 502(b)(6) is intended to limit only those damages which a lessor would have avoided but for the lease termination. See In re Best Prod., Inc., 229 B.R. 673 (Bankr. E.D. Va. 1998) (relied upon Atlantic Container to conclude that landlord was entitled to claim for deferred maintenance damages); In re Bob's Sea Ray Boats, 143 B.R. 229 (Bankr. D. N.D. 1992) (followed Atlantic Container to allow claim for damages for failure to maintain premises). In Atlantic Container, the court thoroughly considered the application of Section 502(b)(6):

- "[D]amages resulting from the termination of a lease" does not contemplate the type of damages sought in a claim for a breach of repair and maintenance obligations. Any damages caused to the leased premises by the debtor's failure to fulfill its repair and maintenance obligations are unrelated to the termination of the lease. Atlantic Container, 133 B.R. at 987.

- The formula for calculating the maximum allowable claim for termination damages under Section 502(b)(6) suggests that the primary purpose of the section is to limit claims for prospective damages resulting from the termination. Section 502(b)(6)(B) permits a lessor to claim, without limitation, the entire amount of rent which is due and owing under the lease as of the earlier of the bankruptcy filing date and the date the lessee ceased to occupy the premises. Claims for *future rent* under the lease, however, are subject to a statutory limit. Id. at 987.
- History of the development of Section 502(b)(6). Concern was over claims for future rent arising from breaches of long-term leases, not claims arising from prepetition events. Id. at 987-88.

In light of these considerations, the courts in Atlantic Container, Best Prod., and Bob's Sea Ray Boats, all concluded that a landlord's claim for its repair and maintenance expenses which resulted from a debtor's breach of lease covenants is not subject to the Section 502(b)(6) cap. The landlord in Foamex urged the court to reach the same conclusion.

C. Foamex Decision

Acknowledging that "well-reasoned decisions [exist] on both sides of the argument," the Foamex court was "satisfied that McSheridan is the better view, particularly when the Third Circuit's decision in First Bank adopted the reasoning of McSheridan and did so applying bankruptcy law." Foamex, 368 B.R. at 393. In particular, the Foamex court was convinced that McSheridan was the more reasoned approach for two reasons:

First, the [McSheridan] court premised its holding on the basis that:

Such an interpretation fulfills the purpose of "discharg[ing] the debtor from liability to future suits based upon the lease 'and giving' a new and more certain remedy for a limited amount, in lieu of an old remedy inefficient and uncertain in its result."

Second, the [McSheridan] court looked to the legislative history and Sections 365(d)(3), 365(g), 502(g) and 502(b)(6), and read them "as a whole" to support its ruling. Thus, the court concluded:

[T]he provisions of § 502(b)(6)(A) encompasses damages arising from breach of any and all lease covenants upon termination of the lease.

Foamex, 368 B.R. at 393-94 (internal citations omitted). Accordingly, the court concluded that the landlord was entitled to a single claim that is subject to the Section 502(b)(6) cap. Id.

III. Saddleback Valley Community Church v. El Toro Materials Co. (In re El Toro Materials Co, Inc.), 504 F.3d 978 (9th Cir. 2007)

Just five months after the Foamex decision was entered the Ninth Circuit issued the El Toro opinion, Saddleback Valley Community Church v. El Toro Materials Co. (In re El Toro Materials Co, Inc.), 504 F.3d 978 (9th Cir. 2007).

In El Toro, the landlord brought an adversary proceeding against the debtor claiming \$23 million in damages for the alleged cost of removing mining debris ("wet clay 'goo'"), equipment, and other materials under theories of waste, nuisance, trespass, and breach of contract. The bankruptcy court found that the landlord's recovery would not be limited by the Section 502(b)(6) cap, but the Ninth Circuit BAP reversed based on its precedent in McSheridan. The Ninth Circuit reversed, noting "[t]o the extent that McSheridan holds Section 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant's failure to complete a lease term, it is overruled." El Toro, 504 F.3d at 981-82.

As grounds for its decision, the Ninth Circuit cited two justifications – one based on statutory analysis, and the other based on policy considerations. In looking at the legislative history and Section 502(b)(6), the Ninth Circuit concluded that the cap was intended to only limit claims "based on a loss of future rental income." Id. at 980. The Ninth Circuit reasoned that the cap made sense with respect to lost rental income because landlords have the ability to mitigate their damages by re-leasing or selling the premises, but to limit recovery for collateral damages was inconsistent with congressional intent of "providing compensation to each creditor in proportion with what it is owed." Id. Since the Section 502(b)(6) cap only applies to claims "resulting from" the rejection of the lease, a "simple test" can be conducted to determine whether the cap should apply:

A simple test reveals whether the damages result from the rejection of the lease: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?

Id. at 981. Because the landlord would have same nuisance, waste and breach of contract claims against the debtor whether the lease was assumed or rejected, the Ninth Circuit concluded that the cap was not applicable. "The million-ton heap of dirt was not put there by the rejection of the lease – it was put there by the actions and inactions of [the debtor] in preparing to turn over the site." Id.

As for its policy considerations, the Ninth Circuit was unwilling to include collateral damage claims within the Section 502(b)(6) cap for two stated reasons: (1) the court was concerned that doing so would create a "perverse incentive" for tenants to reject leases that were beneficial to estate but for the "unrelated damages" that the debtor would seek to cap by rejection; and (2) if included in the cap, tenants with a debt to the landlord already in excess of the cap could cause further damage to the property and would not be deterred against "even the most flagrant acts in violation of the lease." Id.

The Ninth Circuit overruled McSheridan only to the extent it conflicted with the facts contained in El Toro. The Ninth Circuit was careful to distinguish the two cases and to note that it would not otherwise address the propriety of McSheridan because "the tort claims at issue in [El Toro] are not based on a failure to perform future routine maintenance," as were the claims in McSheridan. *Id.* at 982, n.8. While the Ninth Circuit made sure to differentiate the two cases, the opinion suggests that McSheridan's days may be numbered. Noting that two of three BAP judges "expressed reservations" about McSheridan, the Ninth Circuit suggested that the time was ripe for the Ninth Circuit BAP to adopt an en ban procedure to review precedents that are wrongly decided or otherwise deserve reconsideration. *Id.* at 982, n.7. Nevertheless, El Toro did not decide that claims for breach of repair and maintenance covenants necessarily fall outside of the Section 502(b)(6) cap. Accordingly, even under El Toro, claims for "routine maintenance" may still be subject to the cap – although it certainly seems that the Ninth Circuit (and perhaps even the Ninth Circuit BAP) is inclined to rule otherwise.

On April 14, 2008, the United States Supreme Court denied the debtor's petition for writ of certiorari.

IV. Conclusion

The law concerning whether the Section 502(b)(6) cap applies to repair and maintenance obligations remains unsettled, especially in the wake of the El Toro and Foamex opinions on the subject. But given that El Toro has called into question the viability of McSheridan – the seminal case for application of the cap, the path for a more consistent approach may have been set. While El Toro technically only overruled McSheridan to the extent it differed from the facts in that case (tort claims), the rationale underlying El Toro is in line with Atlantic Container and other cases that have concluded that McSheridan was decided wrongly. Absent McSheridan, it is not unreasonable to assume that Foamex and other courts that have concluded that the Section 502(b)(6) cap applies to repair and maintenance claims would have decided the issue differently. However, given the continued uncertainty on the matter, debtors and landlords are likely to continue this potentially big-money dispute. One thing is for certain; the next court that is faced with the issue will have a choice between two very distinct lines of cases.