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*209 SIZING UP THE "CAP" COMMERCIAL LEASE REJECTION CLAIMS IN BANKRUPTCY

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I. Introduction

One of the primary reasons that a business entity will consider seeking relief under the Bankruptcy Code [FN2] is that it cannot generate sufficient cash flow to sustain its operations. Typically, when such an entity files for relief under chapter 7 [FN3] of the Bankruptcy Code or chapter 11, [FN4] it will seek to stem the loss of cash by rejecting unexpired leases of nonresidential real property, [FN5] thereby relieving the debtor as lessee of the obligation to perform under the lease. [FN6]

Lease rejections have often defined large, complex chapter 11 cases. Recent cases such as *Kmart* [FN7] and *Edwards Theatres* [FN8] involved dozens to hundreds of lease rejections.

***210** Lease rejections also may play a vital role in smaller chapter 11 and chapter 7 cases, where the entire business operation may revolve around a single lease or few leased locations. [FN9]

Regardless of whether a debtor leases hundreds of retail outlets through the country or a single location on the local Main Street, its ability to reject unexpired leases is one of the fundamental powers granted by the Bankruptcy Code. [FN10] However, that power comes at a cost - rejection gives rise to a general unsecured claim for rejection damages, [FN11] which damages generally are measured by the amount of rent due for the remaining term of the lease. Absent a limitation on the amount of damages that a landlord can claim for future rent, lease rejection claims might often otherwise dwarf the claims of other trade creditors and employees, especially for commercial real property leases, which frequently have lengthy multi-year terms.

Congress recognized the concern that one subset of the general unsecured creditor pool - commercial landlords - could dominate the entire bankruptcy case as a result of the gross amounts of their rejection claims. Thus, since its enactment in 1978, the Bankruptcy Code has contained a limitation or "cap" on ***211** claims arising from the rejection of a commercial lease. That "cap" is found in Bankruptcy Code section 502(b)(6), which provides that a lease rejection claim is allowed 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 served 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 ....

In effect, through Bankruptcy Code section 502(b)(6), Congress limited the amount of damages that a landlord could claim upon rejection of a lease to a maximum portion of the "rent reserved" for the remaining term of the lease plus any "unpaid rent" previously due under the lease. The section 502(b)(6) "cap" is an important tool available to debtors, and can provide debtors (and prospective debtors) leverage in negotiating with landlords over lease restructuring, in and out of bankruptcy.

Notwithstanding the importance of the "cap," the text of Bankruptcy Code section 502(b)(6) raises as many questions as it answers. What does "rent" mean? May a landlord recover late fees, interest, attorneys' fees and other obligations under a lease if the debtor rejects the lease? How does the formula in 11 U.S.C. section 502(b)(6)(A) work? What role do guarantees, security deposits, letters of credit and concepts of mitigation play in calculating a section 502(b)(6) claim?

In order to provide guidance to counsel representing creditor landlords and debtor tenants alike, this article addresses some of the more important issues relating to the "cap." Part II addresses the evolution of the treatment of damage claims for future rent in a bankruptcy context, beginning with the Bankruptcy Act of 1898 (the "Bankruptcy Act") and running through the enactment of the ***212** Bankruptcy Code in 1978. Part III discusses the scope of recovery on account of a lease rejection claim, including analysis of the meaning of "rent" and whether section 502(b)(6) limits non-rent claims that nonetheless arise from the breach of a lease. Part IV provides an explanation of the mechanics of calculating the "cap," including a discussion of the appropriate starting date for measuring the "rent reserved" as limited by the "cap." Last, Part V analyzes the effect of various concepts relating to a lease rejection claim that are external to the text of Bankruptcy Code section 502(b)(6), including whether the "cap" applies to debtor and nondebtor guarantors, how the presence of security deposits and/or letters of credit might affect the application of the "cap," and the role that a landlord's mitigation plays in calculating a lease rejection claim. [FN12]

In order to aid the discussion, this article makes use of the following hypothetical:

Debtor files a chapter 11 case on January 1, 2004 (the "Petition Date"). As of the Petition Date, Debtor, as lessee, and Landlord, as lessor, are parties to a triple-net lease of commercial real property (the "Lease") in a shopping mall. On the Petition Date, Debtor rejects the Lease. Thereafter, Debtor proposes a plan of reorganization

that provides for a $100,000 distribution to be shared pro rata among Debtor's general unsecured creditors. Excluding Landlord, there are ten other general unsecured creditors, each of whom hold a $48,500 allowed claim.

As of the Petition Date, the term of the Lease runs until December 31, 2013. For the first year of the remaining term, the monthly rent, common area maintenance charges, insurance and taxes are $10,000. During the next four years, monthly rent, common area maintenance charges, insurance and taxes increase to $12,500. During the last five years of the lease, monthly rent, common area maintenance charges, insurance and taxes total $15,000. If Debtor is late in making a monthly rent payment, the Lease provides that Landlord can impose a 10% late fee. If Debtor defaults under the Lease, the Lease provides that Landlord can recover any attorneys' fees and costs incurred relating to the default. The Lease also provides that any monetary obligation under the Lease is deemed to be "rent."

***213** *Six months prior to the Petition Date, Debtor vacated the leased premises and delivered a notice of surrender to Landlord. Landlord, however, delivered a letter to Debtor stating that, although Debtor was in default, Landlord would not accept surrender of the leased premises. One month prior to the Petition Date, and unbeknownst to Debtor, vandals caused $100,000 in damages to the vacated leased premises. Under the Lease, Debtor is obligated to maintain the leased premises in substantially the same condition as when Debtor first occupied the premises. As of the Petition Date, Landlord had incurred $50,000 in attorneys' fees*.

II. The Evolution of Lease Rejection Claims in Bankruptcy

The "cap" imposed on lease rejection claims, now codified at Bankruptcy Code section 502(b)(6), has a history, long preceding the adoption of the Bankruptcy Code. Understanding the pre-Code history leading up to the adoption of Bankruptcy Code section 502(b)(6) is a crucial step in determining whether Congress intended for the "cap" in section 502(b)(6) to continue with pre-Code practice, radically depart from it, or end up somewhere in between. [FN13]

As originally enacted, the Bankruptcy Act was silent regarding the status of landlord claims for future rent based on breach or termination of an unexpired real property lease. [FN14] The Bankruptcy Act did not expressly allow such claims to be proven, nor did it impose any kind of limitation on the amount of such claims. [FN15] When confronted with landlord claims for future rent, courts interpreting the Bankruptcy Act initially held that such claims were not provable because they were contingent and unfixed. [FN16] Because the landlord's claim for ***214** future rent could not be proven, the landlord did not receive a distribution from the bankruptcy estate, but instead would retain its claim against the debtor's corporate shell.

However, judicial resistance to the provability of contingent claims gradually eroded over time, so that by the early 1930's, landlords were succeeding in proving damage claims for future rent. [FN17] This shift in jurisprudence coincided with the Great Depression, during which time it became even more difficult to assess the future rental value of a property. The combination of the uncertain economic climate and the specter of provable future rent claims highlighted two previously unaddressed problems: (i) the liquidation of a claim for future rent; and (ii) the effect of that claim on the distribution to a debtor's other creditors.

In 1934, Congress amended the Bankruptcy Act to address these problems by specifically making claims for

"injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease" provable in an amount not to exceed "the rent, without acceleration, reserved by said lease" for a maximum of one year in a liquidation [FN18] and three years in a corporate reorganization. [FN19] In the case of a liquidation, the ***215** start date for the one year maximum was "the date of the surrender of the premises." In the case of a reorganization, the three years started from the earlier of "the date of surrender of the premises to the landlord or the date of reentry of the landlord." In both types of cases, the landlord was also allowed to prove a claim for "unpaid rent accrued" up to the start date of the one or the three year period, as applicable.

The 1934 amendment represented a compromise between the then recent decisions holding future rent claims under properly drafted leases to be fully provable and prior decisions holding that future rent claims could never be proven. [FN20] Courts interpreted the amendment to reflect a balance between the Bankruptcy Act's rehabilitative motives (which could be thwarted if large future rent claims were not discharged along with the debtor's other liabilities) and the Bankruptcy Act's focus on an equitable distribution to all creditors (which could be upset by allowing large future rent claims to dwarf the claims of other creditors). [FN21]

In 1938, Congress enacted the Chandler Amendments to the Bankruptcy Act, which provided a few slight modifications to the cap on damage claims for future rent in a liquidation. [FN22] The most significant of these modifications was the addition of the "date of re-entry of the landlord" as an alternative start date for the one year rent cap period, bringing the liquidation provision in line with the reorganization provisions (except for the one year vs. three year difference). [FN23]

From 1938 until 1978, the cap on future rent claims remained unchanged. In 1978 Congress enacted the Bankruptcy Code to replace the Bankruptcy Act. The Bankruptcy Code preserved the cap on future rent claims as section 502(b)(7) of title 11. [FN24]

***216** As compared to the cap under the Bankruptcy Act, section 502(b)(6) provides three main modifications: (i) the addition of the sliding scale set forth in section 502(b)(6)(A); (ii) the alteration of the description of the definition of the claims that are subject to the cap from damages for rejection of a lease or breach of a covenant under such lease to "damages resulting from the termination" of the lease; [FN25] and (iii) the addition of the petition date as the last possible date for measuring a "future rent" claim.

True to its historical roots, section 502(b)(6) is the result of a compromise, this time between the House version of that section and the Senate version. [FN26] The House version was essentially identical to the version of section 502(b)(6) currently in effect, except that the House version's alternative maximum claim was 10% of the remaining term of the lease, rather than the 15% set forth in the enacted version of section 502(b)(6). [FN27]

In contrast, the Senate version preserved the Bankruptcy Act's distinction between liquidations and reorganizations, such that damage claims for future rent were capped at one year of rent reserved in a case under chapter 7 and three years of rent reserved in case under chapters 9, 11 or 13. [FN28] The compromise provided for the retention of the House formulation, which contained identical treatment for cases under all chapters of the Bankruptcy Code, but with an increase of the alternative maximum amount from ten to fifteen percent. [FN29]

The legislative history of section 502(b)(6) highlights the historical motivation for retaining a cap on future rent claims by noting that the cap is "designed to compensate the landlord for his loss while not permitting a claim so large (based on a long term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate." [FN30] Specifically, Congress made reference to two underlying reasons for the Bankruptcy Act's original imposition of that cap: (i) the concern that the amount of damages suffered by a landlord resulting from a tenant's breach of a lease is contingent and difficult to prove; and (ii) in a true lease, the landlord retains all of the risks and benefits as to the value ***217** of the real estate at the termination of the lease, such that equity supports a limit on the landlord's claims. [FN31]

Other than being renumbered as section 502(b)(6), the bankruptcy "cap" on a landlord's damage claim for future rent has remained unchanged since the Bankruptcy Code was enacted in 1978.

III. The Scope of a Landlord's Recovery on a Lease Rejection Claim

The text of Bankruptcy Code section 502(b)(6) indicates that landlords whose leases have been rejected actually hold two claims. The first claim, codified at 11 U.S.C. § 502(b)(6)(A), is for "rent reserved" under the lease, the amount of which is limited to the greater of one year's rent or "15 percent, not to exceed three years, of the remaining term of such lease," which is measured from the earlier of the date of "repossession," the date of "surrender" or the petition date. Essentially, the section 502(b)(6)(A) claim is for future rent that the landlord expected to receive had the lease not been rejected, subject to the limitations imposed by the statute.

The second claim, codified at 11 U.S.C. § 502(b)(6)(B), grants the landlord a claim for any "unpaid rent" accrued prior to the date of measuring the "future rent" claim of section 502(b)(6)(A). This "unpaid rent" claim is not subject to the one year / 15% limitation in section 502(b)(6)(A).

On the surface, this equation might sound simple enough, but in practice the computation is complicated by the fact that the Bankruptcy Code does not define the phrases "rent reserved" and "unpaid rent." Nor does the "cap" answer the question whether a landlord may recover additional claims arising under a lease other than "rent."

A. The Bankruptcy Code's Meaning of "Rent"

Both components of Bankruptcy Code section 502(b)(6) expressly use the term "rent" as the keystone for determining the scope of the "cap." [FN32] Commercial leases often designate every monetary obligation as "rent," such that late fees, ***218** interest, attorneys' fees, and any other conceivable obligation to pay the landlord cash will be deemed "rent" under the lease.

While the term "rent" is not defined in the Bankruptcy Code, a number of courts interpreting Bankruptcy Code section 502(b)(6) have held that the term "rent" is imbued with a federal meaning, and that meaning is determined by reference to a three part test, first articulated by the Ninth Circuit Bankruptcy Appellate Panel in *Kuske v. McSheridan (In re McSheridan)*. [FN33]

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 the 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. [FN34]

The *McSheridan* court's three part test is premised on the common law understanding of what constitutes “rent.” [FN35] “Rent” at common law essentially meant compensation paid by a tenant to a landlord for the use and occupancy of property, [FN36] and thus finds its roots in the very essence of the landlord tenant relationship. Using *McSheridan's* rubric, “rent” includes the monthly rental payments, costs of insuring the leased property, taxes on the leased property, or common area maintenance charges, if applicable. Each of these charges relates to the value of the property and each charge is fixed, regular and/or periodic as long as the tenant is performing under the lease. [FN37]

***219** Under *McSheridan*, “rent” should not include attorneys' fees and costs, interest, late fees, and other one-time expenses, such as tenant improvement obligations or construction obligations. [FN38] Each of these charges either are one-time charges, or occur only if there has been a default under the lease.

Edwards Theatres cogently explained why one-time charges are not “rent” even though the lease happens to designate such charges as “rent.” In *Edwards Theatres*, the debtor entered into a lease with a landlord, which lease obligated the debtor to construct a movie theatre at the debtor-tenant's own cost. [FN39] The lease designated all monetary obligations as “rent.” On the day that the debtor commenced its chapter 11 case, the lease was rejected. The landlord argued that it was entitled to include as a part of its lease rejection claim the cost of constructing the theatre, contending that the debtor's construction obligation constituted “unpaid rent” within the meaning of Bankruptcy Code section 502(b)(6)(B). [FN40]

The court rejected the landlord's argument, holding that the construction obligation did not constitute “rent” under the *McSheridan* test:

> [T]he construction obligation does not relate to the value of the leased premises or the value of the Lease. The Lease is for the pad upon which the Theatre was to be built at [the debtor's] sole expense. [The landlord] had no obligation to pay for the construction costs. Thus, as in *Smith*, [the landlord] had no expectation to recoup any costs incurred by [the debtor] in building the Theatre and installing furniture, fixtures, and equipment. [FN41]

***220** The court further held that the construction obligation failed to satisfy the third prong of the *McSheridan* test because the obligation was “a one-time performance obligation that did not require [the debtor] to pay anything to [the landlord]. In addition, the construction obligation did not establish any fixed, periodic, or regular charges that [the debtor] was to pay its contractors or subcontractors to construct the Theatre.” [FN42]

While *McSheridan* itself discussed "rent" in the context of Code section 502(b)(6)(A), courts have properly extended *McSheridan*'s three part test to apply to the term "unpaid rent" in Code section 502(b)(6)(B). [FN43] This rule is sound, since there is no identifiable basis for using different meanings for the identical word "rent" used in both subsections.

Not all courts follow *McSheridan* or its rationale. The court in *In re Q-Masters, Inc.*, [FN44] held that a landlord's claim for prepetition property damages, interest, and attorneys' fees arising under a lease constituted "rent" within the meaning of Bankruptcy Code section 502(b)(6)(B) because the lease designated such items as "rent." [FN45] Similarly, in *In re Clements*, [FN46] the court held that "all sums due under the lease at the time of the filing of the petition should be included as part of [a landlord's] claim." [FN47] The landlord in *Clements* was permitted to recover attorneys' fees in addition to taxes, insurance and maintenance expenses. Thus, even though the trend appears to favor *McSheridan*, practitioners advising clients as to the effects of rejection must remember that there is a split in authority.

B. Should the "Cap" Limit All Claims Arising Under the Lease to Only "Rent" Claims

Even if attorneys' fees, late fees, interest, construction obligations and other similar charges do not constitute "rent" within the meaning of the "cap," it can be argued that the landlord should be able to recover such claims independent of Bankruptcy Code section 502(b)(6) if the lease provides the landlord a right to recover such charges. There is some force to this argument, both in terms of the ***221** language of section 502(b)(6) and in terms of policy. First, Bankruptcy Code section 502(b)(6) refers only to "lease termination claims" - it does not expressly refer to other claims arising under a lease, but which do not relate to the actual termination of a lease.

Second, limiting landlords to a single recovery of "rent" as capped may create undue hardship on a commercial landlord in certain circumstances, such as in a "build to suit" lease where a debtor rejects the lease prior to beginning construction. [FN48]

Yet, *McSheridan* forcefully concludes 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." [FN49] *McSheridan* further states that the lease termination claim contemplates all breaches at "all time intervals." [FN50] Under *McSheridan*, a landlord gets a single claim for lease termination damages, which claim is measured by Bankruptcy Code section 502(b)(6). That single claim encompasses damages resulting from breaches of the lease that occur both prepetition and postpetition. [FN51] If a portion of the claim is disallowed under Code section 502(b)(6), then the landlord should not be permitted to recover a separate, additional claim. [FN52]

In *McSheridan*, the Ninth Circuit Bankruptcy Appellate Panel grounded its conclusions on three arguments. First, interpreting section 502(b)(6) in this manner "fulfills the purpose of 'discharging the debtor from liability to future suits ***222** based on 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.'" [FN53]

Second, this interpretation is consistent with pre Code practice under Bankruptcy Act sections 63a(9) and 63c. [FN54]

Third, section 502(b)(6) must be read in conjunction with other provisions of the Bankruptcy Code, including sections 365(d)(3), 365(g), and 502(g), which collectively suggest that:

> [A]s a whole, 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. The damages are those resulting from nonperformance of the debtor's obligations under the lease. *Mr. Gatti's*, 162 B.R. at 1011. 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. [FN55]

Some courts have cleaved an exception from *McSheridan* to account for claims arising both from a rejected lease (which would otherwise be subject to the restrictions of *McSheridan*) and from tort. The most common example of this carve-out is damages to the leased premises caused by the debtor. [FN56]

***223** The court in *In re Best Prods. Co*. [FN57] provided the most exhaustive challenge to *McSheridan's* rationale that a landlord who is a party to a rejected lease is entitled to a single claim, subject to the limitations of section 502(b)(6). In *Best Products*, a landlord sought allowance of a claim for deferred maintenance in excess of $1.6 million, which the lease obligated the debtor to perform. [FN58] This claim was in addition to an approximate $1 million claim for "future rent" under Bankruptcy Code section 502(b)(6)(A). [FN59] The debtor objected to the claim, arguing that under *McSheridan* and *Mr. Gatti's*, deferred maintenance charges were damages resulting from the rejection of the lease, and thus subject to the provisions of section 502(b)(6).

The court rejected the debtor's argument, refusing to follow *McSheridan*. [FN60] The court reasoned that *McSheridan* rested "upon a somewhat tortured analysis of the relevant code sections" [FN61] and did not find support in the legislative history of section 502(b)(6) or its predecessor, Bankruptcy Act section 63(a)(9). [FN62]

***224 C. Applying *McSheridan* to the Hypothetical**

Accepting the *McSheridan* test as the proper test for determining the scope of section 502(b)(6), under our hypothetical the landlord would have at least two distinct claims: (i) a claim for prospective future rent under Bankruptcy Code section 502(b)(6)(A), the amount of which is calculated below; and (ii) a claim for the $100,000 in damages to the premises, assuming that such damages sound in tort.

Furthermore, as discussed in Part IV below, the landlord may have a third claim for the six months of prepetition "unpaid rent" following the debtor's abandonment of the leased premises, which, if it is in fact "unpaid rent," would be allowed under Bankruptcy Code section 502(b)(6)(B).

IV. Calculating the Cap

Understanding the scope of recovery under Bankruptcy Code section 502(b)(6) does not answer the question of how to mechanically calculate a lease rejection claim under the "cap." There are at least two issues relating to the mechanics of calculating the "cap" - determining the proper measure date, and divining the meaning of "or 15 percent,

not to exceed three years, of the remaining term of such lease." [FN63]

A. Determining the Proper Measuring Date

As noted above, there are two components to a capped leased rejection claim - the "future rent" claim of section 502(b)(6)(A) and the "unpaid rent" of section 502(b)(6)(B). The dividing line between the "future rent" claim and the prepetition "unpaid rent" claim is set forth in section 502(b)(6)(A) as the earlier of: (i) the debtor's petition date; (ii) the date that the debtor "surrendered" the leased property; or (iii) the date that the landlord "repossessed" the leased property. [FN64] A landlord has every incentive to use the latest possible date (which invariably would be the Petition Date) because the "unpaid rent" claim, which necessarily includes "rent" not paid through the Petition Date, is not capped. Debtors (and other creditors), however, would prefer to minimize the "unpaid rent" claim by using either the "surrender" date or the "repossession" date.

***225** Determining the Petition Date is easy to do, but determining when a "surrender" or "repossession" has occurred is more difficult. Bankruptcy Code section 502(b)(6)(A) does not define what constitutes the "surrender" date or the "repossession" date. Courts that have tackled the issue universally have held that the terms "surrender" and "repossession" are defined in accordance with applicable state law. [FN65]

California law provides a typical example of how state law treats a "surrender" or "repossession" of real property. Under California law, a "surrender" requires two actions. First, the lessee must "abandon" the property by leaving "the premises vacant with the avowed intention not to be bound by his lease." [FN66] Second, the landlord must "accept" the abandonment. [FN67] The effect of a valid surrender is a termination of the lease. [FN68] "Repossession" generally means the physical repossession of leased property from a debtor, either because the debtor has abandoned the property or because the landlord has evicted the debtor. Unlike "surrender," "repossession" under California law does not necessarily terminate the lease. [FN69]

Notwithstanding the weight of authority interpreting "surrender" and "repossession" in conjunction with the state law meaning of those terms, it is far from clear that state law should control the meaning of "surrender" and "repossession" as those terms are used in Bankruptcy Code section 502(b)(6)(A). ***226** To the contrary, there is a strong argument that those terms have a unique federal meaning.

Bankruptcy Code section 502(b)(6) necessarily recognizes a distinction among the terms "lease termination," "surrender" and "repossession." This recognition is made clear by the plain language of Bankruptcy Code section 502(b)(6). The first clause in that section states: "if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property ...." [FN70] Section 502(b)(6)(A) then limits "future rent" to:

> rent reserved by 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 premises .... [FN71]

The fact that Congress decided to measure the limitation on the "future rent" portion of a lease termination claim by the earlier of "lessee's surrender," "lessor's repossession," and the petition date is telling, for at least three reasons.

First, it indicates that Congress did not view "lessee's surrender" or "lessor's repossession" to mean the same thing as "lease termination." Had Congress intended for "surrender" or "repossession" to mean "lease termination," it could have said so by defining the "future rent" component in section 502(b)(6)(A) with reference to the earlier of lease termination or the petition date. [FN72]

***227** Second, in the statute, Congress modified the term "surrender" by the word "lessee" and modified the term "repossession" by the word "lessor." [FN73] These modifications indicate that Congress intended for "future rent" claims be measured from the surrender date, as determined by the tenant's acts, or the date of "repossession," as determined by the landlord's acts. Were the term "surrender" to encompass a landlord's acceptance, it would be inaccurate to modify "surrender" by the term "lessee" because the act of surrender could not occur without the participation of the landlord.

Third, the term "surrender" is used in one other place in the Bankruptcy Code -- section 365(d)(4) -- which states in relevant part:

> [I]f the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is a lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee *shall immediately surrender* such nonresidential real property to the lessor. [FN74]

Section 365(d)(4) thus requires a trustee to *surrender* leased property subject to a rejected lease to a landlord. The use of "surrender" in sections 365(d)(4) and 502(b)(6) should be identical. [FN75] Yet applying the state law concept of "surrender" to section 365(d)(4) necessarily leads to an absurd result -- if "surrender" requires both abandonment and a landlord's acquiescence, how can a trustee comply with section 365(d)(4) if the landlord does not acquiesce to the "surrender?" Not surprisingly, courts interpreting section 365(d)(4) have impressed a federal meaning to its use of the word "surrender." The Ninth Circuit has held that under section 365(d)(4), a debtor must physically surrender the leased property to the landlord even if state law would otherwise require the landlord to seek additional remedies. [FN76]

***228** The only bankruptcy court decision addressing this issue was decided by Judge Klein in *Iron-Oak Supply*. Though the court recognized that it "is axiomatic that the meaning of a word in a federal statute is question of federal law," [FN77] the court concluded that federal "interests do not necessitate a specialized meaning of 'surrendered' in connection with prepetition actions by landlords and tenants." [FN78] Judge Klein reasoned that as a "general rule, bankruptcy law leaves the allocation of property rights in the assets of a bankruptcy estate to the state laws that create and define those property rights ... [s]tate laws are suspended in bankruptcy only to the extent that they actually conflict with the Bankruptcy Code." [FN79]

The *Iron-Oak Supply* case is not persuasive. It does not recognize that the word "surrender" appears in only two sections of the Bankruptcy Code, both of which have the effect of federal law imposing itself on state law principles.

[FN80]

B. Applying the Measure Date to the Hypothetical

Going back to our hypothetical, Debtor gave notice of abandonment, and vacated the premises, six months prior to the Petition Date. A court interpreting "surrender" to require both a debtor's abandonment and a landlord's acceptance of such abandonment would not find a "surrender," and thus the earliest trigger date would be the Petition Date. Accordingly, Landlord would be entitled to an uncapped, "unpaid rent" claim equal to six months' rent (or $60,000) plus its "future rent" claim as capped by section 502(b)(6)(A).

However, if a court were to view "surrender" under the alternative federal law analysis, then the trigger date for determining when the "future rent" claim ***229** begins would be the date that the debtor gave notice and vacated the premises. In this scenario, Landlord would not have an uncapped, $60,000 "unpaid rent" claim, but instead would have only a capped "future rent" claim running from the date that the Debtor vacated the premises.

C. The "15% Rent" Rule Versus the "15% Time" Rule

The next issue relating to the mechanics of calculating the "cap" is the meaning of the phrase "or 15 percent, not to exceed three years, of the remaining term of such lease." Courts have split over this issue. The majority of courts use the "15% Rent" Rule, [FN81] while a few courts use the "15% Time" Rule. [FN82]

The "15% Rent" Rule interprets the sliding scale contained in section 502(b)(6)(A) to require a calculation of fifteen percent of the remaining amount of money due and owing on the lease. This rule generally favors landlords because it accounts for rent escalations often found in long term commercial leases. Applying the "15% Rent" Rule to our hypothetical, and using the Petition Date as the trigger date, Landlord would hold an allowed "future rent" claim in the amount of $243,000. [FN83]

The "15% Time" Rule, on the other hand, looks at the remaining term under the lease. Judge Klein explained in *Iron-Oak Supply*:

> The correct interpretation [of section 502(b)(6)(A)], however, is that the Congress intended that the phrase "remaining term" be a measure of time, not rent. *Sunbeam-Oster*, 145 B.R. at 828, *aff'g In re Allegheny Int'l, Inc.*, 136 B.R. 396, *cited with approval*, *Financial News*, 149 B.R. at 353. The statute is worded in terms of time periods. *Sunbeam-Oster*, 145 B.R. at 828, *Allegheny Int'l, Inc.*, 136 B.R. at 402.
>
> ***230** The phrase "without acceleration" only makes sense in terms of a reference to the next succeeding period under the lease. Taking fifteen percent of all the rent for the remaining term, especially where escalation clauses are present, would be tantamount to effecting an acceleration. [FN84]

Applying the "15% Time" Rule to the hypothetical presented herein, Landlord holds an allowed "future rent" claim in the amount of $195,000. [FN85]

Though this article does not agree with *Iron-Oak Supply*'s analysis as it relates to the meaning of the word "surrender" in section 502(b)(6), Judge Klein's careful review of the meaning of "or 15 percent, not to exceed three years, of the remaining term of such lease" the authors believe it correctly ties the calculation methodology to the plain language of the section.

Regardless of whether the "15% Time" Rule or the "15% Rent" Rule is the correct methodology, in light of the unsettled nature of the law on this issue, practitioners should perform both calculations. [FN86]

V. Additional Limitations on Capped Lease Rejection Claims

A. Application of the 502(b)(6)(A) "Cap" to Guarantors

Section 502(b)(6) limits "the claim of a lessor for damages resulting from the termination of a lease of real property." The statute clearly applies when the ***231** landlord is making a claim against a tenant who is a debtor in bankruptcy. But what happens when a third party guarantees the tenant's obligations under the lease and the landlord asserts a claim against the guarantor (presumably because the tenant would not/could not fulfill its obligations)? Is the guarantor entitled to the benefits of the "cap?" Does the answer depend on whether the guarantor is a debtor?

A significant majority of reported cases hold that if the guarantor is a debtor, then section 502(b)(6) applies to limit the landlord's claim. [FN87] Some courts hold that this result follows from a literal reading of the statute--on its face, section 502(b)(6) does not include or exclude guarantors, but instead focuses on limiting "the amount of a lessor's damages that may be recovered from a bankruptcy estate, where the damages arise from the termination of a lease." [FN88] Other courts concur with decisions interpreting the cap under the Bankruptcy Act, finding that "principles of rateable distribution are equally applicable in the case of a debtor-guarantor as they are in the case of a debtor-principal." [FN89]

Courts routinely distinguish or criticize the one reported case in which a debtor-guarantor was denied the benefit of the 502(b)(6) cap on future rent. [FN90] In *In re Danrik, Ltd.*, [FN91] the Court's holding was premised on the case's unusual facts: (i) the debtor paid all of its other creditors in full; (ii) the debtor's plan had already ***232** been confirmed; (iii) the landlord's claim was not disproportionately large; and (iv) the tenant was not a debtor. [FN92]

In contrast, bankruptcy courts uniformly hold that when a tenant files for bankruptcy, its nondebtor guarantor is not entitled to the benefits of the 502(b)(6) cap. [FN93] One court found this conclusion to be dictated by common sense, posing the question "[W]hat good is a guaranteed lease if the guarantor escapes liability when the debtor does?" [FN94] Therefore, a guarantor's status as a debtor (versus a nondebtor) will almost certainly be determinative with respect to whether the landlord's claim against the guarantor is limited by the "cap."

B. Effect of Security Deposit on 502(b)(6) Calculation

In addition to third party guarantees, landlords also frequently require security deposits from tenants in order to ensure a further source of recovery in the event that the tenant defaults under the lease. When a tenant who has paid a

security deposit seeks bankruptcy protection, the application of section 502(b)(6) must take that security deposit into account.

***233** There are at least two possible ways for a security deposit to be applied in light of the 502(b)(6) cap:

> **Option (1)**: The security deposit could be paid in full to the landlord to reduce the landlord's maximum "future rent" claim. Section 502(b)(6)(A) would then be applied to that reduced claim in order to determine the maximum additional amount that the landlord is entitled to claim directly from the debtor's estate; [FN95] or
>
> **Option (2)**: Section 502(b)(6) could be applied to determine the maximum amount of "future rent" that the landlord is entitled to claim from the debtor's estate without any reduction for the security deposit. Once that amount is determined, the security deposit would then be paid over to the landlord in satisfaction of its 502(b)(6) claim, with the excess, if any, to be returned to the debtor, and the deficiency, if any, to be allowed as an unsecured claim.

These two options may produce significantly different results. Returning to our hypothetical, assuming a security deposit of $300,000 and the use of the "15% Rent" Rule, under Option (1) Landlord would retain the full $300,000 deposit and be entitled to a 502(b)(6) "future rent" claim of $198,000, for a total potential recovery of $498,000. [FN96] Using those same assumptions, under Option (2) Landlord would retain only $243,000 from the security deposit in complete satisfaction of its 502(b)(6) "future rent" claim, with the remaining $57,000 to be ***234** paid over to Debtor's estate. [FN97] Therefore, in our hypothetical the choice between Option (1) and Option (2) results in a potential difference of $255,000. [FN98]

It should come as no surprise that landlords have advocated the use of Option (1) from the moment that the "cap" was first imposed under the Bankruptcy Act. Nonetheless, the Second Circuit held in *Olddenn* that Option (2) was the proper method for applying the "cap," where the landlord had taken a security deposit. [FN99] In doing so, the court noted that the use of Option (1) would mean that "a landlord with security would be able to exceed the statutory limit [based on the amount of] the security it holds, and that landlords would receive different treatment in bankruptcy proceedings, depending upon the existence and size of the security in their possession." [FN100] The court went on to state in dicta that if the landlord's security deposit exceeded the amount of its capped claim (under Option (2)), then the balance must be returned to the estate to avoid a forfeiture. [FN101]

The legislative history for current section 502(b)(6) expressly states that:

> This paragraph will not overrule *Olddenn*, or the proposition for which it has been read to stand: 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 ... As under *Olddenn*, [the landlord] will not ***235** be permitted to offset his actual damages against his security deposit and then claim for the balance under this paragraph. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph." [FN102]

Courts applying section 502(b)(6) in cases where the landlord is in possession of a security deposit have remained true to the legislative history by using Option (2). [FN103] Therefore, in the hypothetical described above, Landlord would retain $243,000 of its $300,000 security deposit in complete satisfaction of its 502(b)(6) "future rent" claim, with the remaining $57,000 to be paid over to Debtor's estate. Using the same assumptions, [FN104] if Landlord's

security deposit had only been $150,000, then Landlord would retain the full security deposit in partial satisfaction of its 502(b)(6) "future rent" claim and be allowed an unsecured claim for the remaining $93,000.

The security deposit in *Oldden* was of the traditional variety - a cash payment made by the tenant at the inception of the lease and held by the landlord to secure the tenant's obligations under the lease. [FN105] Due to the increasingly prevalent use of letters of credit ("LC's") to secure a tenant's obligations under a lease, courts recently have been asked to determine whether Option (2) (as opposed to Option (1)) also applies to a landlord's draw on an LC. [FN106]

Landlords point out that in the event of a default under a lease, an LC does not give the landlord a claim against the tenant--instead, the landlord has a direct ***236** claim against the issuer of the LC. [FN107] As a result, landlords argue that LC's are not subject to the section 502(b)(6) cap because LC's are not property of the estate. [FN108] If courts were to accept the landlord position, then Option (1) would apply and the landlord would be entitled to draw down an LC and receive an allowed "future rent" claim for any deficiency, subject to the limits of section 502(b)(6).

In each of two published decisions and one recent unpublished decision addressing this issue, the court rejected a landlord's contention that Option (1) should apply, finding instead that an LC posted by the debtor and any proceeds thereof must receive the same treatment that any other security deposit would receive (i.e. Option (2)). [FN109] In reaching that conclusion, all three courts refused to rely on case law holding that LC's are not property of the estate, but focused instead on the parties' intentions regarding the effect of the LC, as indicated by language of the lease in question and the effect that LC draws would have on the debtor's estate. [FN110]

In *Stonebridge*, the lease defined "Security Deposit" to include both a traditional cash payment and an LC. [FN111] The court held that "the proceeds of the Letter of Credit must be applied as the parties bargained for-- as a security deposit for the Lease." [FN112] In *PPI*, a rider to the lease authorized the tenant to provide an LC "in lieu" of the cash security deposit otherwise required. [FN113] The Third Circuit ***237** found that the rider demonstrated the parties' intent for the LC to "serve as a security deposit." [FN114]

In *Mayan Networks*, the lease provided that the LC was delivered "as security for the faithful performance by [the debtor] of all of [the debtor's] obligations under this Sublease." [FN115] In addition, the debtor had pledged enough cash to the bank to fully secure the LC. [FN116] The Ninth Circuit Bankruptcy Appellate Panel expressly declined to follow *PPI* in light of the court's recent decision holding that the similar section 502(b)(7) "cap" on employee claims should not be reduced by an employee's draws on an LC. [FN117]

However, the *Mayan Networks* court also declined to follow *Condor* with respect to the section 502(b)(6) "cap" based on its conclusion that the landlord's draw on the LC would trigger the issuing bank's secured claim against the pledged cash collateral, thereby reducing the amount of money left in the estate to pay unsecured claims. [FN118] The court opined that if Option (1) were applied in that case, section 502(b)(6) would be "nullified by crafty draftsmanship" because the debtor would be liable for the full "cap" amount to the landlord and lose the collateral pledged to the LC issuer. [FN119] In order to avoid that result, the court was compelled to hold that when a lease describes an LC as security for the lease and the LC is fully secured by a cash deposit, draws on the LC must be treated like any other security deposit under Option (2). [FN120]

In distinguishing *Condor*, the court in *Mayan Networks* ignores the fact that even when a debtor has not pledged any collateral to secure its obligations to the LC issuer, the issuer could still assert an unsecured reimbursement claim ***238** against the debtor for any draws by the landlord on the LC. Any distribution on that claim would reduce the amount of money in the estate available to pay other unsecured claims, albeit in a more diluted fashion than if the issuer had foreclosed on the debtor's collateral. If the policy against giving effect to "crafty draftsmanship" set forth in *Oldden* is to be maintained, then Option (2) should be applied regardless of whether the debtor's obligation to the LC issuer is secured or unsecured.

Furthermore, the common thread among *Stonebridge*, *PPI* and *Mayan Networks* is the required finding that the parties intended for the LC to serve as a security deposit under the lease before Option (2) will be applied to postpetition landlord draws on an LC. However, none of the three cases suggests whether the same is true for LC's that are *not* intended to serve as a security deposit under the lease, nor do these cases provide a framework for determining whether any such intent exists. [FN121] Because it is difficult to conceive of any purpose to be served by requiring a tenant to post an LC in connection with a lease other than to provide security from which the landlord can recover, all LC's posted by tenants in connection with a lease may satisfy the "intention" test in practice.

Moreover, if the assumption from *Condor* regarding the application of sections 502(e) and 509(c) to LC issuers is correct, then the maximum aggregate amount that a landlord and the issuer of an LC securing such landlord's claim can recover from a debtor's estate should be limited to the section 502(b)(6) "cap" amount, even if Option (1) is applied. [FN122] Under this assumption, the *Mayan* court's grounds for distinguishing *Condor* would be illusory because the use of Option (1) would not reduce the amount of money available for other creditors.

Therefore, although *Mayan Networks*, *Stonebridge* and *PPI* each apply Option (2) to a landlord's draws on an LC, the reasoning behind all three of these decisions is suspect in light of *Condor*. If the *Condor* assumption that sections 502(e) and 509(c) apply to LC issuers is correct, then Option (1) should be applied to LC's posted as security, just as it is applied to third party guarantees and in the 502(b)(7) context. Counsel representing landlords should be aware of the *Condor* holding and its potential applicability under section 502(b)(6), while counsel representing tenants should seek confirmation from any court applying Option (1) that sections 502(e) and 509(c) will apply to the LC issuer.

***239 C. Accounting for Mitigation in the 502(b)(6) Analysis**

The final factor in the 502(b)(6) analysis to be considered by this article is the effect that any mitigation undertaken by a landlord will have on the amount of the "future rent" claim that the landlord will be allowed, if any.

In order to understand the relevance of mitigation to the 502(b)(6) analysis, it is important to remember that section 502(b)(6) does not provide a formula for calculating a landlord's actual rejection damages -- it merely establishes the maximum amount of those damages that the landlord can claim from a debtor's estate. [FN123] As a result, courts must look to applicable nonbankruptcy law and to the lease itself in order to determine the full amount of a landlord's rejection damages. [FN124] A landlord will be allowed a claim for rejection damages under a lease in an amount equal to "the lesser of (i) its total rejection damages, which may take mitigation into account, and (ii) the statutory cap computed under § 502(b)(6)." [FN125]

Thus, if the landlord enters into a new lease for the premises at the same or higher rent, then the landlord will not be allowed any claim for rejection damages. [FN126] Conversely, if the landlord is unable to re-let the premises for the same or higher rent, then the allowable amount of the landlord's rejection damage claim will depend on a comparison between its total rejection claim and the 502(b)(6) "cap" amount. If the 502(b)(6) "cap" applied to limit the landlord's claim, the "cap" amount is not further reduced to account for a landlord's successful mitigation efforts (because mitigation has already been taken into account to calculate the total rejection claim). [FN127]

Returning to our hypothetical, assume that the "15% Time" Rule is used, such that the 502(b)(6)(A) cap on "future rent" damages is $195,000. Assume ***240** further that Landlord is able to find a new tenant willing to lease the premises starting on January 1, 2005 and extending beyond the end of Debtor's original lease term, at the same yearly rates that Debtor would have paid. If Landlord mitigates its damages by entering into the lease with the new tenant, Landlord's actual "future rent" damages will be $120,000. Therefore, Landlord's "future rent" claim will be limited to $120,000, which is the lesser of its actual "future rent" damages and the 502(b)(6)(A) cap. [FN128]

If the scenario is modified slightly, such that the rent under the new lease is only one half of the rent that the Debtor would have paid, starting on January 1, 2005, then Landlord's actual "future rent" damages rise to $870,000. [FN129] Sticking with the same "15% Time" Rule calculation for the 502(b)(6)(A) cap on "future rent" damage claims, Landlord would be limited to the $195,000 "cap" amount because it is less than Landlord's actual "future rent" damages.

One potential problem in applying the mitigation analysis is that it may be impossible to know whether the landlord has successfully mitigated its damages at the time the 502(b)(6) cap is calculated, depending on the length of the lease. For example, the Lease in our hypothetical had ten years remaining on the Petition Date. Even assuming that Landlord's "future rent" claim is calculated 18 months after the Petition Date, there will still be over eight years remaining on the original Lease term. If Landlord has not found a new tenant when the ***241** 502(b)(6) analysis is applied, then Landlord will receive a "future rent" claim for the full cap amount.

But what happens if, on the day after Landlord's "future rent" claim is liquidated, Landlord finds a new tenant willing to lease the premises for the same yearly rent that Debtor would have paid for the final eight and one-half years of the lease? Even though Landlord's total "future rent" damages for purposes of claim allowance were assumed to be $1,620,000, its actual "future rent" damages are now revealed to be $195,000. [FN130] If the "15% Time" Rule had been applied, the result would be the same -- the "cap" amount happens to equal Landlord's actual damages. However, if the "15% Rent" Rule had been applied, then the "cap" would provide Landlord with a windfall because it would have been allowed a "future rent" claim of $243,000, which exceeds its actual damages by $48,000.

To some extent, this problem is simply an inescapable result of long term leases -- in order to be completely accurate, courts would need to wait until the end of a long term lease before calculating the "future rent" claim, at which point it would no longer be "future" rent at all. However, the problem is exacerbated by the fact that not all states require landlords to mitigate their damages upon re-entry of a leased premises. [FN131] As a result, landlords in those states may not have an incentive to pursue replacement tenants during the first few years after a lease is rejected because they are content to rely on a distribution from the bankruptcy estate. [FN132] Instead, such landlords are potentially free to wait until after their "future rent" claim has been allowed in the full 502(b)(6) capped amount to

seek out a new tenant. The 502(b)(6) "cap" amount may even overlap with the new tenant's lease term, resulting in a double recovery for the landlord.

Allowing landlords to obtain windfalls to the detriment of the estate is clearly in contravention of the purpose and function of section 502(b)(6). Fortunately, some courts have held that even where state law does not impose a ***242** duty to mitigate, federal bankruptcy law does. [FN133] Imposing a federal duty to mitigate does not guarantee that a landlord's "future rent" claim will be allowed in the correct amount, but it does provide incentive for landlords to begin mitigation efforts early, especially in those states where mitigation is not otherwise required.

VI. Conclusion

The bankruptcy "cap" on landlord damage claims for future rent originated in the 1930's and has remained unchanged in over twenty five years since the Bankruptcy Code was enacted. Nonetheless, section 502(b)(6) continues to generate reported opinions and legal commentary on a regular basis. A significant portion of the discussion springs from the fact that the statute's precise mathematical clarity in the abstract is frequently obscured by the hazy fact patterns that emerge in practice. This difficulty in application is compounded by the perpetual evolution of commercial leases and the landlord-tenant relationship. In order to keep pace, counsel representing landlord and tenant clients alike would be well advised to develop dexterity with the various future rent claim permutations that section 502(b)(6) can produce, and familiarity with the historical rationale upon which the "cap" on those claims is based.

[FN1]. Eric D. Winston is a shareholder with Stutman, Treister & Glatt Professional Corporation and is the Los Angeles Bankruptcy Forum's forum liaison representative to the *California Bankruptcy Journal*. Nathan A. Schultz is an associate with Stutman, Treister & Glatt Professional Corporation.

[FN2]. *See* 11 U.S.C. § 101 *et seq*.

[FN3]. *See* 11 U.S.C. §§ 701-728. *See also* 11 U.S.C. §§ 741-784 (while Sections 741 to 784 are contained within chapter 7 of the Bankruptcy Code, they uniquely concern stockbrokers, commodity brokers, and clearing banks).

[FN4]. *See* 11 U.S.C. §§ 1101-1146. *See also* 11 U.S.C. §§ 1161-1174 (while sections 1161-1174 are contained within chapter 11 of the Bankruptcy Code, they are specific to railroad liquidations).

[FN5]. Bankruptcy Code section 365(a) provides:

> Except as provided in sections 765 and 766 of this title and in subsections (b), (c) and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

11 U.S.C. § 365(a).

[FN6]. *See In re* Mr. Gatti's, Inc., 162 B.R. 1004, 1012 (Bankr. W.D. Tex. 1994).

[FN7]. *Kmart* and its affiliates commenced their chapter 11 cases on January 22, 2002 in the United States Bankruptcy

Court for the Northern District of Illinois, Jointly Administered Case No. 02-B02474. On the first day of the case, Kmart rejected 267 commercial real property leases. See "Order Under 11 U.S.C. §§ 105(a) And 365(a) Authorizing (A) Rejection Of Certain Unexpired Leases And (B) Approving Procedures For Rejecting Other Unexpired Leases" [Docket No. 119].

[FN8]. *Edwards Theatres Circuit, Inc*. and its affiliates commenced their chapter 11 cases on August 23, 2000 in the United States Bankruptcy Court for the Central District of California, Jointly Administered Case No. 00-16475-JR. The *Edwards* debtors rejected 28 leases from a total of 70 leased properties on the first day of their chapter 11 cases. *See* Docket No. 18 (Order granting motion to reject unexpired leases of nonresidential real property). The authors are members of the firm that represented the *Edwards* debtors.

[FN9]. *See In re* Plitt Amusement Co. of Wash., 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999). *Plitt* concerned a chapter 7 trustee's efforts to reject an unexpired theater lease. The debtor had signed three commercial property leases (including the one to be rejected), a purchase agreement, a promissory note and a security agreement in connection with the purchase of a theater business from the lessor.

[FN10]. *See In re* Nat'l Gypsum Co., 208 F.3d 498 (5th Cir. 2000) (authority to reject is vital to basic purpose of chapter 11 reorganization). A debtor is granted wide discretion to determine which leases to reject, needing only to demonstrate that such rejection constitutes good business judgment. *See, e.g., In re* G.I. Indus., 204 F.3d 1276 (9th Cir. 2000); *In re* Klein Sleep Prods., 78 F.3d 18 (2d Cir. 1996).

[FN11]. *See* 11 U.S.C. § 502(g).

[FN12]. Parts I-V are not intended to list all of the issues relating to the "cap." Among other issues not covered by this article is the question whether a debtor must be insolvent in order to take advantage of the "cap." *See* James Lucian, *Damn Those Damages: An Analysis And Overview Of 11 U.S.C. § 502(b)(6)*, 8 J. BANKR. L. & PRAC. 365, 366 (1999).

[FN13]. Cohen v. de la Cruz, 523 U.S. 213, 221 (1998) ("We ... will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.").

[FN14]. *See* Oldden et al. v. Tonto Realty Corp., 143 F.2d 916, 918 (2d Cir. 1944). For an exhaustively researched discussion of the history and evolution of the bankruptcy cap on damage claims for future rent under unexpired real property leases, *see* Marie T. Reilly, *The Wasted Sacrifices of Lessors' Lost Profit Claims in Bankruptcy*, 60 LA. L. REV. 233 (1999).

[FN15]. The difference under the Bankruptcy Act between a claim that could be "proven" and one that could not was that a "proven" claim would entitle the holder to share in the distribution to unsecured creditors, but the claim did not survive the debtor's discharge, if any, while a claim that was not "proven" did not entitle the holder to share in the distribution, but would survive the debtor's discharge. *See* 4 COLLIER ON BANKRUPTCY, ¶ 502.LH[1][b], at 502-82-84 (15th ed. Rev.).

[FN16]. *See, e.g.*, *Oldden*, 143 F.2d at 918 (citing authorities); *In re* Roth & Appel, 181 F. 667, 669 (2d Cir. 1910); Gardiner v. William S. Butler & Co., 245 U.S. 603, 38 S. Ct. 214 (1918).

[FN17]. *See* Irving Trust Co. v. A.W. Perry, Inc., 69 F.2d 90, 91 (2d Cir. 1934).

[FN18]. Prior to 1933, the Bankruptcy Act was limited to liquidations. In 1933, provisions for individual debtor reorganization (section 74) and railroad reorganization (section 77) were added. *See* Act of March 3, 1933, ch. 204, 47 Stat. 1467, 1468 (repealed 1978). In 1934, Congress added section 77B, which provided for nonrailroad corporate reorganizations. *See* Act of June 7, 1934, ch. 424, 48 Stat. 911 (1934).

[FN19]. Section 77B(b)(10) provided that:

> The claim of a landlord for 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 be treated as a claim ranking on a parity with debts which would be provable under section 63(a) of this Act, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid rent accrued up to such date of surrender or reentry.

Act of June 7, 1934, ch. 424, 48 Stat. 911 (1934). Section 63(a) was amended to provide:

> Debts of the bankrupt may be proved and allowed against his estate which are ... (7) claims for damages respecting executory contracts including future rents whether the bankrupt be an individual or a corporation, but the claim of a landlord for injury resulting from the rejection by the trustee 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 succeeding the date of the surrender of the premises plus an amount equal to the unpaid rent accrued up to said date ....

Act of June 7, 1934, ch. 424, 48 Stat. 923, § 4 (1934).

[FN20]. *See Oldden*, 143 F.2d at 920 (citing authorities).

[FN21]. *See id.* (citing authorities).

[FN22]. *See* Act of June 22, 1938, ch. 575, 52 Stat. 840.

[FN23]. *See id.*

[FN24]. Section 502(b)(7) was redesignated as section 502(b)(6) in the Bankruptcy Amendments and Federal Judgeship Act of 1984; PUB. L. NO. 98-353 (1978).

[FN25]. *See In re* Mr. Gatti's, Inc., 162 B.R. 1004, 1008 (Bankr. W.D. Tex. 1994).

[FN26]. *See* 124 CONG. REC. H11094 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards).

[FN27]. *See* PUB. L. NO. 98-353 (1978).

[FN28]. *See id.*

[FN29]. *See* 11 U.S.C. § 502(b)(6).

[FN30]. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 63-64, *reprinted in* 11 U.S.C.A.§ 502, pp. 584-87 (West 1993).

[FN31]. *See id.*

[FN32]. Commentators have noted that the meaning of "rent" is often the most litigated issue under Bankruptcy Code section 502(b)(6). *See* Lucian, *supra* note 12, at 377, (citing Lisa Sommers Gretchko, *Coping With Rejection, § 502(b)(6)--The Evolving Law of Lease Rejection Damages*, AM. BANKR. INST. J. 36 (Apr. 15, 1996)).

[FN33]. 184 B.R. 91 (B.A.P. 9thCir. 1995); *see also In re* Pacific Arts Publishing, Inc., 198 B.R. 319, 323-24 (Bankr. C.D. Cal. 1996) (following *McSheridan*); *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 348 (Bankr. D. Del. 1998) *aff'd* 324 F.3d 197 (3d Cir. 2003); *In re* Smith, 249 B.R. 328, 337 (Bankr. S.D. Ga. 2000) (collecting cases following *McSheridan*).

[FN34]. *McSheridan*, 184 B.R. at 99-100.

[FN35]. *See id.* at 97.

[FN36]. *See* Santa Monica Rent Control Bd. v. Bluvshtein, 230 Cal. App. 3d 308, 317, 281 Cal. Rptr. 289 (1991). Black's Law Dictionary defines "rent" as "the compensation or fee paid, usually periodically, for the use of any rental property, land, buildings, equipment, etc." BLACK'S LAW DICTIONARY 1297 (6th ed. 1990).

[FN37]. *See, e.g.*, Heck's, Inc. v. Cowron & Co. (*In re* Heck's, Inc.), 123 B.R. 544 (Bankr. S.D. W. Va. 1991) (including taxes, insurance premiums and CAM charges as "rent" subject to section 502(b)(6), but excluding utility charges, janitorial expenses, electrical repairs, and the costs of keys from the cap because they did not bear any relationship to the value of the property or the lease).

[FN38]. *See Smith*, 249 B.R. at 340 (attorneys' fees and amortized tenant improvement obligations); *See also PPI Enters.*, 228 B.R. at 348 (attorneys' fees); *Pacific Arts Pub.*, 198 B.R. at 324 (attorneys' fees); *In re* Rose's Stores, Inc., 179 B.R. 789, 791 (Bankr. E.D.N.C. 1995) (attorneys' fees); *In re* Storage Tech. Corp., 77 B.R. 824, 825 (Bankr. D. Colo. 1986) ("Attorney's fees don't relate to the value or use of the property.").

[FN39]. *In re* Edwards Theatres Circuit, Inc., 281 B.R. 675, 678 (Bankr. C.D. Cal. 2002).

[FN40]. The procedural posture of *Edwards Theatres* was more complicated than presented above. The landlord initially attempted to assert a claim against a debtor-guarantor of the debtor lessee for breach of the construction obligation as a claim separate from the lease rejection claim. After the court disallowed the claim against the guarantor, the landlord sought to amend its lease rejection claim to include the claim for breach of the construction obligation. *Id*. at 678-80.

[FN41]. *Id.* at 684.

[FN42]. *Id.* at 684-85.

[FN43]. *See Smith*, 249 B.R. at 337 ("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).").

[FN44]. *In re* Q-Masters, Inc., 135 B.R. 157, 161 (Bankr. S.D. Fla. 1991).

[FN45]. *Id.* at 161.

[FN46]. *In re* Clements, 185 B.R. 895, 903 (Bankr. M.D. Fla. 1995).

[FN47]. *Id.* at 903.

[FN48]. In *Edwards Theatres*, at the time of the rejection, the debtor had not commenced construction of the theatre. Thus, the landlord was left with a large, undeveloped parcel of land in a shopping center.

[FN49]. Kuske v. McSheridan (*In re* McSheridan) 184 B.R. 91, 102 (B.A.P. 9th Cir. 1995).

[FN50]. *Id.* at 101.

[FN51]. *Id.* at 99-100.

[FN52]. *Id.*; *see also In re* Smith, 249 B.R. 328, 337 (Bankr. S.D. Ga. 2000) (collecting cases following *McSheridan*); *In re* Pacific Arts Publishing, Inc., 198 B.R. 319, 323-24 (Bankr. C.D. Cal. 1996); *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 348 (Bankr. D. Del. 1998) *aff'g* 324 F.3d 197 (3d Cir. 2003). Interestingly, the Ninth Circuit, in an unpublished decision issued prior to the Ninth Circuit Bankruptcy Appellate Panel's decision in *McSheridan*, held that the attorneys' fees a landlord incurred in connection with an action to rescind a lease were not subject to section 502(b)(6), but nonetheless were recoverable by the landlord. *See In re* Field, 940 F.2d 667 (9th Cir. 1991) (table). It is unclear from the *Field* disposition whether the rescission action was brought either before a default under the lease or before the debtor commenced his bankruptcy case.

[FN53]. *McSheridan*, 184 B.R. at 101 (quoting Kuehner v. Irving Trust Co., 299 U.S. 445, 453 (1937)).

[FN54]. *Id.*; *see also* Part II.

[FN55]. *Id*. at 102. Bankruptcy Code section 365(g) provides that, except in the limited circumstances of a timeshare interest, rejection constitutes a breach of an unexpired lease or executory contract. *See* 11 U.S.C. § 365(g). The section does not limit the breach to monetary obligations. Given that elsewhere in Bankruptcy Code section 365, Congress understood the effect of specific provisions in an unexpired lease or an executory contract, such as anti-assignment clauses and ipso facto clauses, *McSheridan* did not err in concluding that rejection constitutes a breach of *every* covenant of a lease. Moreover, commercial landlords are hard pressed to complain in light of Bankruptcy Code section 365(d)(3), which the Ninth Circuit has interpreted to require a debtor to perform every obligation under a lease, even if the lease obligation merely cross-applies an obligation arising under a promissory note, which would not otherwise be within the scope of Bankruptcy Code section 365. *See* Cukierman v. Uecker (*In re* Cukierman), 265 F.3d 846, 850-51 (9th Cir. 2001) (debtor obligated to repay promissory notes under Bankruptcy Code section 365(d)(3) because such obligations are "further rent" under lease).

[FN56]. *See, e.g.*, *In re* Bob's Sea Ray Boats, Inc., 143 B.R. 227 (Bankr. D.N.D. 1992); *In re* Atlantic Container Corp., 133 B.R. 980 (Bankr. N.D. Ill. 1991); *In re* Int'l Coin & Currency, Inc., 18 B.R. 335, 338 (Bankr. D. Vt. 1982) (claim for physical damages to leased premises intentionally caused by debtor gives landlord a claim not subject to section 502(b)(6)); *but see In re* Mr. Gatti's, Inc., 162 B.R. 1004 (Bankr. W.D. Tex. 1994).

[FN57]. 229 B.R. 673 (Bankr. E.D. Va. 1998); *see also* Michael Lichtenstein, *Calculating A Landlord's Claim In Bankruptcy*, 32 REAL ESTATE L.J. 131, 135 (2003).

[FN58]. *Id.* at 674.

[FN59]. *Id.*

[FN60]. *Id.* at 677.

[FN61]. *Id.* at 677-78. The court, however, does not explain how or why it found the analysis in *McSheridan* and *Mr. Gatti's* to be "tortured," nor does it describe the analysis to which it refers.

[FN62]. *Id*. at 678. The court further stated that *McSheridan* represented the minority view. *Id*. at 678. Since publication of *Best Products*, it appears that the majority of courts have followed *McSheridan*'s rationale, *see In re* Smith, 249 B.R. 328, 340 (Bankr. S.D. Ga. 2000); *In re* Edwards Theatres Circuit, Inc., 281 B.R. 675, 684 (Bankr. C.D. Cal. 2002), though in fairness to Judge Tice, the *Edwards Theatres* decision is from a bankruptcy court of the Central District of California, and arguably *McSheridan*, a published decision of the Ninth Circuit Bankruptcy Appellate Panel, binds it. In addition, the only circuit court to cite *McSheridan* cited the case with approval. *See* First Nat'l Bank v. FDIC, 79 F.3d 362, 367 (3d Cir. 1996) (holding that 12 U.S.C. section 1821(e)(4) governs a bank receiver's overall liability for damages when it repudiates a lease, and citing *McSheridan* for the proposition that "analogous portion of

bankruptcy code encompasses all claims for breach of lease; specifically rejecting argument that appellant's claims for prepetition breach of covenants not 'termination' damages and therefore not covered by provision.").

[FN63]. 11 U.S.C. § 502(b)(6)(A).

[FN64]. *Id.*

[FN65]. *See, e.g.*, Mid-Wilshire Assocs. v. Lomax (*In re* Lomax), 194 B.R. 862, 866 (9th Cir. 1996); *see also In re* Iron-Oak Supply Corp., 169 B.R. 414, 418 (Bankr. E.D. Cal. 1994); *In re* Q-Masters, Inc., 135 B.R. 157, 160 (Bankr. S.D. Fla. 1991).

[FN66]. Kassan v. Stout, 9 Cal. 3d 39 (1973).

[FN67]. *See, e.g.*, *In re* Wolverton Assocs., 909 F.2d 1286, 1295 n.5 (9th Cir. 1990) (under California law, "if the lessor manifests an intent not to surrender the lease, this will prevent an otherwise effective surrender of the lease by the lessee."); *Iron-Oak Supply*, 169 B.R. at 418 (collecting California cases and holding that "surrender of a leasehold requires acceptance by the landlord-either implicit acceptance or explicit acceptance."); *see also* BLACK'S LAW DICTIONARY, *supra* note 36, at p. 1444.

[FN68]. *See* 4 WITKIN, SUMMARY OF CALIFORNIA LAW § 664 (9th ed.); *see also Kassan*, 9 Cal. 3d. 39. Some courts applying California law have interchanged the term "surrender" with "abandonment." *See* Rognier v. Harnett, 45 Cal. App. 2d 570, 574 (1941) ("A lease contract may be brought to an end by the surrender of the leased premises and the acquiescence in such surrender by the lessor.") (emphasis added). Part of the confusion stems from the fact that, prior to the enactment of CAL. CIVIL CODE § 1951.20 in 1970, if, after a tenant's abandonment, a landlord retook possession for its own benefit, a surrender was deemed to have occurred. Though these decisions confuse the analysis, they still recognize that an effective surrender terminates a lease.

[FN69]. *See* CAL. CIVIL CODE § 1951.4; *see also* Dorcich v. Time Oil Co., 103 Cal. App. 2d 677 (1951).

[FN70]. 11 U.S.C. § 502(b)(6) (emphasis added).

[FN71]. 11 U.S.C. § 502(b)(6) (emphasis added).

[FN72]. Because Congress used the term "termination" in the first clause of section 502(b)(6), it should be presumed that Congress understood what it was doing when it elected to use the terms "surrender" and repossession" in section 502(b)(6)(A). It is appropriate to examine the terms stated in Bankruptcy Code section 502(b)(6)(A) in light of language employed elsewhere in section 502(b)(6). "'[C]ourts must be wary not to examine one section of a statute in isolation because statutory construction ... is a holistic endeavor.'" Kuske v. McSheridan (*In re* McSheridan) 184 B.R. 91, 101 (B.A.P. 9th Cir. 1995) (quoting *In re* R.H. Macy & Co., 170 B.R. 69, 73 (Bankr. S.D.N.Y. 1994)).

[FN73]. *See* 11 U.S.C. § 502(b)(6)(A)(i) ("the date on which such lessor repossessed, or the lessee surrendered, the

leased property").

[FN74]. 11 U.S.C. § 365(d)(4) (emphasis added).

[FN75]. *See* Cohen v. de la Cruz, 523 U.S. 213 (1998); U.S. Nat'l Bank of Oregon v. Independent Ins. Agents of Am., Inc., 508 U.S. 439 (1993); Allen v. CSX Transp., Inc., 22 F.3d 1180 (D.C. Cir. 1994); Boise Cascade Corp. v. Environmental Protection Agency, 942 F.2d 1427 (9th Cir. 1991).

[FN76]. Anderson v. Elm Inn, Inc. (*In re* Elm Inn, Inc.), 942 F.2d 630, 634 (9th Cir. 1991).

[FN77]. *In re* Iron-Oak Supply Corp., 169 B.R. 414, 417 (Bankr. E.D. Cal. 1994).

[FN78]. *Id.*

[FN79]. *Id*. One potential criticism of reading "surrender" to require only a debtor's abandonment is that such an interpretation arguably grants too much leverage to the debtor. It is possible to imagine a savvy potential debtor, in the hopes of restructuring its commercial lease, simply abandoning the leased premises and threatening bankruptcy, knowing that it has already locked in the capped amount of the landlord's claim by virtue of its "surrender." However, such a tactic is only likely to be employed by the rare tenant who is either: (i) very confident that the landlord will agree to a restructuring; (ii) very certain that the lease in question is not worth keeping or marketing under its current terms; or (iii) both. Absent one of these alternatives, the surrender gambit is not likely to be worth the risk that the landlord will accept the debtor's tender of the premises and effect a lease termination before the debtor can file its bankruptcy petition.

[FN80]. In fact, courts have recognized that section 502(b)(6) is a pronouncement of federal law that trumps state law. *See In re* Thompson, 116 B.R. 610, 613 (Bankr. S.D. Ohio 1990).

[FN81]. *See In re* Andover Togs, Inc., 231 B.R. 521, 545 (Bankr. S.D.N.Y. 1999); *see also* M. Lichtenstein, *supra* note 57, at 136 (discussing majority and minority views).

[FN82]. *See, e.g.*, *Iron-Oak Supply*, 169 B.R. at 420; Sunbeam-Oster Co. v. Lincoln Liberty Ave., Inc., 145 B.R. 823, 828 (W.D. Pa. 1992).

[FN83]. As indicated in the hypothetical, the first year's rent equals $120,000; the next four years, at $150,000 per year, equals $600,000; and the last five years, at $180,000 per year, equals $900,000, for a total of $1,620,000. 15% of $1,620,000 equals $243,000.

[FN84]. *Iron-Oak Supply*, 169 B.R. at 420.

[FN85]. 15% of the 10-year term is 1.5 years. Under the hypothetical, the first year's rent equals $120,000, and the next half year's rent equals $75,000, for a total of $195,000. Whether a court applies the "15% Rent" Rule or the "15%

Time" Rule can have additional effects in bankruptcy, such as impacting the debtor's ability to confirm a plan of reorganization. In the hypothetical, there are ten other general unsecured creditors, each holding a $48,500 claim. If a court applies the "15% Rent" Rule, and assuming that the ten general unsecured creditors and Landlord vote in the same class (*see* 11 U.S.C. § 1122), Landlord could block acceptance by such class of any plan proposed by Debtor because Landlord would hold more than 33.33% of the claims voting in such class ($243,000 out of an aggregate claim amount of $728,000 equals 33.38%). *See* 11 U.S.C. § 1126(c). Under the same assumptions, but using the "15% Time" Rule instead, Landlord would hold less than 33.33% of the claims voting in the class, and could not unilaterally block class acceptance ($195,000 out of an aggregate claim amount of $680,000 equals only 28.68%).

[FN86]. This is especially true for debtor's counsel, who must be careful to be consistent in a case involving multiple rejected leases. It is very possible that one rejected lease will give rise to a lower "future rent" claim using the "15% Rent" Rule, while another rejected lease will give rise to a lower "future rent" claim using the "15% Time" Rule.

[FN87]. *See In re* Arden, 176 F.3d 1226, 1229 (9th Cir. 1999); *In re* Episode USA, Inc., 202 B.R. 691, 694-95 (Bankr. S.D.N.Y. 1996); *In re* Interco Inc., 137 B.R. 1003, 1007 (Bankr. E.D. Mo. 1992); *In re* Revco D.S., Inc., 138 B.R. 528, 532 (Bankr. N.D. Ohio 1991); *In re* Rodman, 60 B.R. 334, 335 (Bankr. W.D. Okla. 1986).

[FN88]. *Interco*, 137 B.R. at 1005 (emphasis added). *See also Arden*, 176 F.3d at 1229; *Episode USA, Inc.*, 202 B.R. at 695.

[FN89]. *Rodman*, 60 B.R. at 335 (citing *Oldden*). *See also Revco*, 138 B.R. at 531 (same); Oldden et al. v. Tonto Realty Corp., 143 F.2d 916, 921 (2d Cir. 1944) (citing authorities in dicta for the proposition that the Bankruptcy Act's cap on future rent applied to guarantors because otherwise "a guarantor in a reorganization is liable for more than his principal; that cannot be the meaning of the statute; the guaranty is a secondary obligation and must be subject to the same limitations as the primary.").

[FN90]. *See, e.g.*, *Arden*, 176 F.3d at 1226 (citing authorities, including United States v. Ron Pair Enters., Inc., 489 U.S. 235, 109 S. Ct. 1026 (1989)); *Revco*, 138 B.R. at 532; *Interco*, 137 B.R. at 1006-07.

[FN91]. *In re* Danrik, Ltd., 92 B.R. 964 (Bankr. N.D. Ga. 1988).

[FN92]. *Danrik*, 92 B.R. at 970-72. Facts (i) and (iii) removed any concern that the distribution to the debtor's other unsecured creditors would be unfairly reduced based on the landlord's claim, fact (ii) suggested that the debtor's re-organization would not be impeded without the application of the "cap," and fact (iv) ensured that the guarantor would not be liable for more than the tenant, since the cap was not available to the tenant as a nondebtor. *See id*.

[FN93]. *See, e.g.*, *In re* Modern Textile, Inc., 900 F.2d 1184, 1191 (8th Cir. 1990) (relying on section 524(e) of the Bankruptcy Code, which provides that a discharge does not affect the liability of a nondebtor entity); Bel-Ken Assoc. Ltd. Partnership v. Clark, 83 B.R. 357, 358-59 (D. Md. 1988) (same, but recognizing that bankruptcy court could limit nondebtor guarantor's liability to prevent landlord from recovering "disproportionately large claims").

[FN94]. *Bel-Ken*, 83 B.R. at 359. The court did not address the apparent conflict between its common sense rationale and the proposition advanced in *Oldden* that a guarantor's liability should not exceed that of its principal. Furthermore, despite the apparently rhetorical nature of the question, one possible answer is that although a landlord might receive little to nothing for its capped "future rent" claim against a debtor-tenant's estate, it would presumably receive the full value of its claim against a nondebtor guarantor, especially if that claim were also capped by section 502(b)(6). However, the clear implication of section 524(e) is that the "cap" cannot be used to limit a landlord's claims against a nondebtor guarantor.

[FN95]. Option (1) apparently would apply where a third party guarantee, rather than a security deposit, secures the debtor's obligations under the lease. *Cf. In re* Mayan Networks Corp., 2004 WL 369886 at *4 (B.A.P. 9th Cir. 2004) (citing authorities, including *Bel-Ken* and *Modern Textile*).

[FN96]. As indicated *supra*, note 83, the total "future rent" due under the Lease is $1,620,000, reduced by the $300,000 deposit equals $1,320,000. 15% of $1,320,000 equals $198,000. Therefore, the use of Option (1) in combination with the "15% Rent" Rule reduces Landlord's 502(b)(6) "future rent" claim by $45,000 (or 15% of $300,000).

If the "15% Time" Rule were used, Landlord would retain the $300,000 deposit and be entitled to a 502(b)(6) "future rent" claim of $195,000, for a total potential recovery of $495,000. Therefore, if Option (1) is used in combination with the "15% Time" Rule, the presence of a security deposit has absolutely no effect on the amount of a landlord's 502(b)(6) "future rent" claim, which is simply added to the forfeited security deposit.

[FN97]. If the "15% Time" Rule methodology were used in combination with Option (2), Landlord would retain $195,000 from the security deposit, with the remaining $105,000 to be paid over to the estate.

[FN98]. Using the "15% Time" Rule results in a potential difference between Option (1) and Option (2) of $300,000 (i.e., the amount of the security deposit). The use of Option (2) vs. Option (1) under the "15% Time" Rule has a greater effect than under the "15% Rent" Rule because under Option (1), the presence of a security deposit reduces the landlord's "future rent" claim when the "15% Rent" Rule is used, but has no effect on the landlord's "future rent" claim when the "15% Time" Rule is used.

[FN99]. *See* Oldden et al. v. Tonto Realty Corp., 143 F.2d 916, 921 (2d Cir. 1944).

[FN100]. *Id.* at 920. In a spirited dissent, Justice Frank contended that landlords in possession of a security deposit ought to retain the benefit of their bargains in the same way that secured creditors do. *See id.* at 922. Thus, Option (1) would allow the landlord to fully recover the value of its security interest, and to the extent that a deficiency remained, the landlord would be entitled to an unsecured claim to which the cap would then be applied. *See id.* Justice Frank obviously disagrees with the majority opinion's contention that under Option (2), the landlord still retains "the full benefit" of its security through the application of the deposit to the landlord's capped claim, which provides a landlord in possession of a security deposit with "full payment in place of the usual small dividend." *Id.* at 921.

[FN101]. *See id.* at 921.

[FN102]. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 63-64, *reprinted in* 11 U.S.C.A. § 502, pp. 584-87 (West 1993).

[FN103]. *See, e.g.*, Solow v. PPI Enters. (U.S.), Inc. (*In re* PPI Enters. (U.S.), Inc.), 324 F.3d 197, 208 (3d Cir. 2003) (citing *Oldden* and legislative history); Faulkner v. EOP-Colonnade of Dallas, L.P. (*In re* Stonebridge Techs.), 291 B.R. 63, 68-69 (Bankr. N.D. Tex. 2003); *In re* Handy Andy Home Improvement Centers, Inc., 222 B.R. 571, 575 (Bankr. N.D. Ill. 1998) (finding statute to be ambiguous and relying on *Oldden* and legislative history); *In re* Atlantic Container Corp., 133 B.R. 980, 989 (Bankr. N.D. Ill. 1991) (dicta).

[FN104]. *I.e*. that the "15% Rent" Rule is used.

[FN105]. Oldden et al. v. Tonto Realty Corp., 143 F.2d 916, n.2 (2d Cir. 1944).

[FN106]. *See, e.g.*, *PPI*, 324 F.3d at 208-10; *Stonebridge*, 291 B.R. at 69-72; *In re* Mayan Networks Corp., 2004 WL 369886 (B.A.P. 9th Cir. 2004).

[FN107]. *See PPI*, 324 F.3d at 209; *Stonebridge*, 291 B.R. at 69 (reciting tri-partite nature of LC's: (i) underlying contract between debtor and beneficiary, i.e. the lease; (ii) debtor's contract with the LC issuer; and (iii) issuer's contract to pay the beneficiary); *Mayan Networks*, 2004 WL 369886 at *3.

[FN108]. *See PPI*, 324 F.3d at 209; *Stonebridge*, 291 B.R. at 69; *Mayan Networks*, 2004 WL 369886 at *id*.

[FN109]. *See PPI*, 324 F.3d at 210; *Stonebridge*, 291 B.R. at 70-72; *Mayan Networks*, 2004 WL 369886 at *5 (unpublished as of the date this article went to print).

[FN110]. *See PPI*, 324 F.3d at 210. (acknowledging Musika v. Arbutus Shopping Ctr., L.P., 257. B.R. 770, 772 (Bankr. D. Md. 2001)); *Stonebridge*, 291 B.R. at 71 (distinguishing *Musika* based on its facts and its failure to address the application of section 502(b)(6) to LC's); *Mayan Networks*, 2004 WL 369886 at *3 (acknowledging *Musika*, but stating that "the fact that letters of credit themselves are not property of the estate is a red herring" because the appropriate analysis "looks to the impact that the draw upon the letter of credit has on property of the estate").

[FN111]. *See Stonebridge*, 291 B.R. at 65.

[FN112]. *Id.* at 71 (citing *PPI*).

[FN113]. *PPI*, 324 F.3d at 210.

[FN114]. *Id.*

[FN115]. *Mayan Networks*, 2004 WL 369886 at *1.

[FN116]. *See id.*

[FN117]. *See id*. at *4 (citing *In re* Condor Systems, Inc., 296 B.R. 5 (B.A.P. 9th Cir. 2003)). In *Condor*, the court assumes, without citing any authority, that the issuer of an LC is "an entity that is liable with the debtor on or has secured the claim of [the landlord]" for purposes of sections 502(e) and 509(c) of the Bankruptcy Code. *Id*. at 15. If that assumption is correct, sections 502(e) and 509(c) could be read to ensure that the maximum aggregate amount that an employee, and the issuer of an LC securing such employee's claim, could recover from a debtor's estate would be limited to the section 502(b)(7) "cap" amount, even if the "cap" is not reduced by the amount of any draws on the LC. See *id*. at 19.

[FN118]. *See id*. at *5.

[FN119]. *Id*. at *4-5 (quoting *Oldden*).

[FN120]. *See id*. at *5.

[FN121]. *See* Solow v. PPI Enters. (U.S.), Inc. (*In re* PPI Enters. (U.S.), Inc.), 324 F.3d 197, 208 (3d Cir. 2003) (refusing to decide whether LC's are inherently subject to cap under section 502(b)(6) because LC was intended to operate as security deposit).

[FN122]. Nothing in sections 502(e) and 509(c) suggest that these sections should be applied differently in the 502(b)(6) context, than they are in the 502(b)(7) context.

[FN123]. *See In re* Iron-Oak Supply Corp., 169 B.R. 414, 419 (Bankr. E.D. Cal. 1994) (Section 502(b)(6) "merely establishes a limit and does not constitute a substantive damages remedy."); *In re* First Alliance Corp., 126 B.R. 589, 591 (Bankr. S.D. Cal. 1994), *rev'd in part on other grounds*, 140 B.R. 531 (B.A.P. 9th Cir. 1992) (Section 502(b)(6) "merely qualifies and limits the lessor's claim to a maximum.").

[FN124]. *See First Alliance Corp.*, 126 B.R. at 591.

[FN125]. *In re* Episode USA, Inc., 202 B.R. 691, 696 (Bankr. S.D.N.Y. 1996). *See also Iron-Oak Supply*, 169 B.R. at 419; *First Alliance Corp.*, 126 B.R. at 591.

[FN126]. *See In re* Highland Super Stores, Inc., 154 F.3d 573, 577 (6th Cir. 1998).

[FN127]. *See, e.g.*, *In re* Goldblatt Bros., Inc., 66 B.R. 337, 347-48 (Bankr. N.D. Ill. 1986); *In re* Bob's Sea Ray Boats, Inc., 143 B.R. 227, 231 (Bankr. D.N.D. 1992); *Iron-Oak Supply*, 169 B.R. at 420.

[FN128]. The outcome does not change if the "15% Rent" Rule is used instead. Under that rubric, the Landlord's future rent damages would remain $120,000, which would still be less than the 502(b)(6)(A) "cap" of $243,000. Therefore, the Landlord would also be allowed a $120,000 "future rent" claim under the "15% Rent" Rule.

However, it is important to remember that if the "15% Rent" Rule is used, the 15% amount should be determined

based upon the total rent reserved under the lease and not the total rejection damages. In at least one reported case, this calculation was performed incorrectly, such that the rent reserved under the lease was reduced to reflect the landlord's successful mitigation and then multiplied by 15% for purposes of calculating the 502(b)(6)(A) cap. *See Bob's Sea Ray Boats, Inc.*, 143 B.R. at 232. This method of calculating the cap is at odds with the language of the statute, wherein 15% modifies the "remaining term" of the lease and not "damages resulting from [its] termination.' *See* 11 U.S.C. § 502(b)(6). Moreover, mitigation is already taken into account when the cap amount is compared to the landlord's actual "future rent" damages, as set forth above. Therefore, the better application of section 502(b)(6) under the "15% Rent" Rule is to calculate the 15% amount based upon the total rent reserved under the lease without any reduction for mitigation.

[FN129]. Under the new lease, Landlord would receive zero rent for 2004; $75,000 per year for the next four years, equals $300,000; and $90,000 per year for the last five years, equals $450,000, for a total of $750,000. As indicated above, a total of $1,620,000 was due from Debtor to Landlord over the remaining term of the Lease. $1,620,000 minus $750,000 equals $870,000 in lost rent.

[FN130]. Remaining rent reserved of $1,620,000, minus $150,000 per year for three and one half years ($525,000), minus $180,000 for five years ($900,000), equals $195,000 in lost rent.

[FN131]. According to a recent A.L.R. annotation, case law in roughly half of the states surveyed required a landlord to mitigate damages. *See* Christopher Vaeth, Annotation, *Landlord's Duty, On Tenant's Failure To Occupy, Or Abandonment Of, Premises, To Mitigate Damages By Accepting Or Procuring Another Tenant*, 75 A.L.R. 5th 1 (2003). The California cases cited declined to impose a duty to mitigate. *See id*.

[FN132]. The likelihood of this is tempered somewhat by the unlikely prospect of recovering the full amount of such a claim from the bankruptcy estate.

[FN133]. *See In re* Handy Andy Home Improvement Centers, Inc., 222 B.R. 571, 575 (Bankr. N.D. Ill. 1998); *Bob's Sea Ray Boats, Inc.*, 149 B.R. at 231 (citing *Goldblatt*); D.H. Overmeyer Co. v. Irving Trust Co., 60 B.R. 391, 397 n.7 (S.D.N.Y. 1986) (decided under Bankruptcy Act predecessor statute to section 502(b)(6)).

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