By Michael St. James

Final Open Issue Resolved Regarding the Landlord Cap

In the last days of 2016, the Ninth Circuit published a decision resolving the last great battleground in the application of the cap on landlords' claims in bankruptcy, thereby establishing a comprehensive jurisprudence. At least within the Ninth Circuit, the rules that govern the calculation of a landlord's claim for lease-termination damages are now clear.

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The Landlord's Cap

Since the 1930s, landlords have been permitted to assert rejection-damage claims for future rent, but those claims have been subject to an arbitrary statutory maximum limitation (called the "landlord's cap"), typically amounting to one year's worth of rent. The landlord's cap was enacted in the Bankruptcy Code as § 502(b)(6), which disallows a claim:

> (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, [and] such claim exceeds —
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> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of —
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> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
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> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

It is important to note that the statute and the following discussion is presented in terms of a lease "termination," not a "rejection." The two words are not identical, although in the vast majority of cases, "termination" will be the consequence of "rejection" by a tenant in bankruptcy.[1] For present purposes, it is important simply to note the issue: Rejection may occur without termination. In considering the application of the landlord's cap, courts must answer three questions of significant financial impact: (1) Are security deposits or other credit enhancements applied before or after the claim is limited by the landlord's cap; (2) what constitutes "rent reserved," the measuring stick that determines the amount of the landlord's cap; and (3) can the landlord have allowable claims that are not limited by the landlord's cap?

In the past two decades, the Ninth Circuit has resolved the first two questions, and its decisions on those questions have generally been met with acceptance or have been consistent with decisional law throughout the nation.[2] However, the third question has significant economic impact because the landlord's damages under state law will typically exceed the landlord's cap, so additional claims that are subject to the landlord's cap will be disallowed in a bankruptcy case, while additional claims that are not subject to the landlord's cap will be entitled to receive a distribution.

With the *Kupfer*[3] decision, the Ninth Circuit established a clear test to identify the claims that a landlord may assert that are *not* limited by the landlord's cap — that is, the claims that do not "result from the termination of a lease." As a consequence, it is possible in the Ninth Circuit to calculate the impact of the Bankruptcy Code on a landlord's unsecured claim for lease-termination damages with certainty. As a result of the soundness and statutory basis for its decision, the Ninth Circuit's approach on this final issue may, as with its resolutions of the two previous issues, meet with general acceptance.

What Claims Are Capped?

Decisional law about whether a landlord can have claims that are not limited by the landlord's cap has been inconsistent and confused. Many courts have taken the position that the landlord's cap limits every claim that a landlord can have, whether or not the claim arose from the termination of a lease, because such claims were necessarily for breaches of some lease covenant, and so are within the intended scope of the landlord's cap.[4] Other courts have attempted more restrictively to

1 *See, e.g., McLaughlin v. Walnut Props. Inc.*, 119 Cal. App. 4th 293, 14 Cal. Rptr. 3rd 369 (2d Dist. Ct. App. 2004) (where tenant reaffirmed and operated under lease post-rejection, breach associated with rejection did not terminate lease), and *Vallely Invs. LP v. BancAmerica Commercial Corp.*, 88 Cal. App. 4th 816, 828-29, 106 Cal. Rptr. 2nd. 689, 699 (4th Dist Ct. App. 2001) (holding that assignee of lease who expressly assumed all of tenant's obligations can be held to those obligations notwithstanding subsequent rejection by subsequent assignee).

2 *See* fns. 10 and 11, *infra.*

3 *Konstantin Kupfer v. Karim Salma (In re Kupfer)*, 14-16697 (9th Cir. 2016).

parse the types of claims that a landlord might have and whether they fell within or outside of the language of the landlord's cap. Typical "battleground" issues have been landlords' claims for deferred maintenance and repair and for attorneys' fees.[5]

For decades, the Ninth Circuit Bankruptcy Appellate Panel (BAP) advocated an expansive view of the landlord's cap under which the cap was thought to cover virtually all the types of claims that a landlord would likely be able to raise in a bankruptcy case.[6] In 2007, through its *El Toro* decision, the Ninth Circuit partially overruled that authority.

El Toro involved unusually compelling facts. The debtor, a mining company, rejected a lease that required less than $30,000 per month in rent, abandoning onsite mining equipment, other materials and "one million tons of its wet clay 'goo,'" which the landlord then paid $23 million to remove. Reversing the BAP, the Ninth Circuit held that the landlord's clean-up expenses were *not* limited by the landlord's cap and could be allowed as a separate and additional claim in the bankruptcy case.

It is easy to see the opinion in *El Toro* as having been driven by its extraordinary facts. The opinion begins by dwelling on applicable bankruptcy and congressional policies. Although the BAP's discussion included the thought experiment that subsequently became the *Kupfer* test, it was scarcely the most prominent part of the decision. Indeed, *El Toro* was generally viewed as holding that while the landlord's cap limited contractual damages, it did not limit a landlord's tort claims:

> We held that tort claims for waste, nuisance, and trespass "do not result from the rejection of the lease; they result from the pile of dirt allegedly left on the property."[7]

As a result, *El Toro* left the state of the law somewhat more confused than it had been previously. The post-*El Toro* "rule" seemed to be this: The landlord's cap generally applies to the landlord's damages relating to the lease, but if those damages were so extraordinary as to represent torts, then they might not be limited by the landlord's cap.

The *Kupfer* Test

In *Kupfer*, the Ninth Circuit took a thought experiment buried in the discussion in *El Toro* and promoted it to a clear and practical test. (In doing so, it followed an approach adopted by the Eighth Circuit BAP the year before.[8]) The Ninth Circuit looked to the statute's language, which applies the landlord's cap to claims "for damages resulting from the termination of a lease," and on that basis applied the following test to determine whether a claim was subject to the landlord's cap:

> Assuming [that] 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?

Where the lease was terminated pre-bankruptcy, the test is, "[a]ssuming [that] all other conditions remain constant, would the landlord have the same claim against the tenant if the lease had not been terminated?" In *Kupfer*, the dispute related to the application of the landlord's cap to attorneys' fees awarded the landlord in connection with litigation in which the landlord (1) sought past-due rent, (2) sought future (post-termination) rent and (3) successfully defended various claims asserted by the tenant/future debtor.

Applying the *Kupfer* test, the Ninth Circuit concluded that the first and third aspects of the attorneys' fee award would be owed even if the lease were assumed or not terminated — and so they *were not* subject to the landlord's cap — whereas the second element of attorneys' fees relating to the recovery of future (post-termination) rent clearly would not arise if the lease were assumed or otherwise not terminated — and thus *was* subject to the landlord's cap. The prior Eighth Circuit BAP decision had applied the same analysis to pre-petition awards of interest on past-due rent (not subject to the landlord's cap), interest on future (post-termination) rent (subject to the landlord's cap), and an award of attorneys' fees (allocated based on whether the fees were incurred prosecuting a claim that was or was not subject to the landlord's cap).

A Comprehensive Landlord's Cap Jurisprudence

With *Kupfer*, the Ninth Circuit brings clarity to the last major disputed issue relating to the landlord's cap. Henceforth, a landlord (at least in the Ninth Circuit) can determine with certainty its allowed claim after application of the landlord's cap by applying the following four steps:

1. Unpaid rent through the petition/surrender date will be allowed and not subjected to the landlord's cap (§ 502(b)(6)(B));
2. All other obligations arising under the lease or associated with the leasehold or the tenancy will be allowed and not subjected to the landlord's cap *if* the obligations would have been owed, *even if* the lease had been assumed/not terminated (the *Kupfer* test);
3. Obligations arising out of the termination of the lease will be subjected to the landlord's cap (the *Kupfer* test); and
4. Any security deposit or letter of credit held by the landlord will be applied against the foregoing[9] (that is, to the landlord's claim *after* it has been capped) (*AB Liquidating*).[10]

4 This view had far better statutory support under the prior Bankruptcy Act, which applied the landlord's cap to "a claim for damages for injury resulting from the rejection of an unexpired lease of real estate *or damages or indemnity under a covenant contained in such lease*," Bankruptcy Act § 63a(9), 11 U.S.C. § 103 (emphasis supplied) than under the current Bankruptcy Code, where the landlord's cap was expressly limited to claims "resulting from the termination of a lease."

5 *See* Michael St. Patrick Baxter, "The Application of § 502(b)(6) to Nontermination Lease Damages: To Cap or Not to Cap?," 83 *Am. Bankr. L.J.* 111, 144-163 (2009).

6 *See Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 102 (B.A.P. 9th Cir. 1995), *overruled in part by Saddleback Valley Cmty. Church v. El Toro Materials Co. (In re El Toro Materials Co.)*, 504 F.3d 978 (9th Cir. 2007) ("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."); *In re Pac. Arts Publ'g, Inc.*, 198 B.R. 319, 324-25 (Bankr. C.D. Cal. 1996) (landlord's attorneys' fees claim arose out of lease and thus was encompassed within landlord's cap); *In re JSJF Corp.*, 334 B.R. 94 (B.A.P. 9th Cir. 2006) (same).

7 *Kupfer, supra* (describing ruling in *El Toro*).

8 *Lariat Co.'s v. Wigley (In re Wigley)*, 533 B.R. 267 (B.A.P. 8th Cir. 2015). This aspect of the *El Toro* decision was treated as dispositive in *In re Denali Family Servs.*, 506 B.R. 73, 79 (Bankr. D. Alaska 2014), and was discussed in *In re Healthy Hut Inc.*, 506 B.R. 526, 531 (Bankr. D. Haw. 2014).

9 Admittedly, *AB Liquidating* was decided before there was an acknowledged body of landlord claims that were not subject to the landlord's cap, but there is no analytical basis to prevent the landlord from applying its security deposit or credit enhancement against such claims.

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In calculating the amount of the landlord's cap, a court will compute the "rent reserved" based on the *McSheridan* rule, a decades-old decision of the Ninth Circuit BAP that has been widely accepted throughout the country:[11]

> We hold that the following three-part test must be met for a charge to constitute "rent reserved" under § 502(b)(6)(A):
>
> 1. The charge must: (a) be designated as "rent" or "additional rent" in the lease; or (b) be provided as the tenant's/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 classifiable as rent because it is a fixed, regular or periodic charge.

Conclusion

The landlord's cap has affected billions of dollars of claims and probably billions of dollars of distributions since the Bankruptcy Code was enacted almost 40 years ago, but it has been the subject of limited and slowly developing decisional law. The Ninth Circuit has now resolved — for landlords and tenants within its jurisdiction — all the key litigation battlegrounds relating to the application and calculation of the landlord's cap. It has established clear tests and rules to determine what claims are subject to the landlord's cap and those that are not, how to calculate the "rent reserved" (the measuring stick of the landlord's cap), and how to apply a security deposit or other credit enhancement to the landlord's claim. This should substantially reduce litigation and uncertainty regarding landlords' rejection damages claims within the Ninth Circuit and, if accepted more broadly, throughout the nation. abi

10 *AMB Prop. LP v. Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*, 416 F.3d. 961 (9th Cir. 2005). The author was counsel for the unsuccessful landlord in *AB Liquidating*. The core ruling of *AB Liquidating* is consistent with the rulings in *Solow v. PPI Enters. Inc. (In re PPI Enters. Inc.)*, 324 F.3d 197 (3d Cir. 2003); *In re Builders Transport Inc.*, 471 F.3d 1178 (11th Cir. 2006); and *EOP-Colonnade of Dallas Ltd. P'ship v. Dennis Faulkner (In re Stonebridge Techs. Inc.)*, 430 F.3d 260 (5th Cir. 2005). The security deposit or credit enhancement likely must be refunded to the extent that it exceeds the total claim, as subjected to the landlord's cap. *Builders Transport, supra* (requiring refund). *Compare Stonebridge Techs., supra* (concluding that landlord's cap is not avoidance power, so if no proof of claim is filed, no refund could be demanded).

11 *McSheridan, supra*, 184 B.R. at 99-100. As previously noted, *McSheridan*'s expansive view of the scope of the landlord's cap has been overruled, but its "rent-reserved" analysis remains universally accepted. *Smith v. Sprayberry Square Holdings Inc. (In re Smith)*, 249 B.R. 328, 337 (Bankr. S.D. Ga. 2000) (discussing broad acceptance of *McSheridan* Rule); *see, e.g., In re PPI Enters. (U.S.) Inc.*, 228 B.R. 339, 350 (Bankr. D. Del. 1998), *aff'd*, 324 F.3d. 197 (3d Cir. 2003); *First Bank Nat'l Ass'n v. FDIC*, 79 F.3d 362, 369 (3d Cir. 1996); *In re MDC Sys.*, 488 B.R. 74, 90 (Bankr. E.D. Pa. 2013); and *In re Premier Entm't Biloxi LLC*, 413 B.R. 370, 277-78 (Bankr. S.D. Miss. 2009).