RECENT DEVELOPMENTS IN BANKRUPTCY CASES AFFECTING LANDLORDS' LEASE REJECTION DAMAGES CLAIMS

Recently decided cases significantly impact landlords' damage claims resulting from a debtor/tenant's rejection of a commercial lease under section 365 of the Bankruptcy Code. Two United States Bankruptcy Court cases signify a landlord may forfeit its claim for future rent if the landlord sells the leased property subsequent to a debtor/tenant's rejection of the lease. Meanwhile, a Ninth Circuit Court of Appeals case expands a landlord's rights after lease rejection by limiting the types of damages subject to the statutory cap under section 502(b)(6) of the Bankruptcy Code. Landlords and tenants should be aware of these developments, both when initially drafting a lease and after a tenant files a bankruptcy petition.

Risks from Post-Rejection Sale of Leased Property

Section 365(a) of the Bankruptcy Code enables a debtor/tenant (or its trustee) to assume or reject an unexpired lease. Pursuant to section 365(g) of the Bankruptcy Code, such rejection constitutes a prepetition breach of the lease giving rise to a landlord's claim for damages. In *In re Fly I, Inc.*[1] the debtor/tenant rejected its lease for real property located in Virginia. Subsequently, the landlord sold the property. The landlord filed a claim for future lease rejection damages exceeding $2 million. That claim was challenged on the basis that the landlord's sale of the premises eliminated the landlord's claim for rejection damages based on rent accruing after the sale.

The Delaware Bankruptcy Court sustained the objection, reasoning that real property rights are governed by state law and the parties' agreement. Under Virginia law, a landlord has three options upon a tenant's breach of a lease: (i) re-enter the premises and terminate the lease; (ii) re-enter for the limited purpose of re-letting without terminating the lease; or (iii) refuse to re-enter and instead initiate an action for accrued rents. The Court found the third option was not applicable because the landlord had re-entered the premises. In determining which of the first two options applied, the Court relied on authority holding that a sale of property subject to a lease was "so inconsistent with the tenant's estate as to allow for no other interpretation than that the landlord had reentered in order to accept a surrender."[2] Hence, the landlord's sale of the property was found to constitute the "exercise of sufficient dominion"[3] over the leased premises as to represent the landlord's acceptance of the debtor/tenant's abandonment and, therefore, no further rent was due from the debtor/tenant.

---

1 377 B.R. 140 (Bankr. D. Del. 2007).

2 377 B.R. at 144 (quoting Wilson v. Ruhl, 356 A.2d 544, 547 (Md. 1976)).

3 Id.

Having concluded that under applicable state law the landlord's conduct constituted an acceptance of surrender cutting off the landlord's right to future rent payments, the Court then analyzed whether the parties had contracted around that result. The Court found that lease provisions potentially overriding state law should be strictly construed and held the lease provisions relied on by the landlord signified the lease did not limit the landlord's state law rights, but did not override state law. Alternatively, the Court found that a lease provision enabling the landlord to collect all rent if the lease were terminated due to the tenant's bankruptcy filing would be an unenforceable *ipso facto* clause under section 365(e)(1) of the Bankruptcy Code, as such a rent acceleration provision was triggered by the tenant's bankruptcy filing.

A similar recent case is *In re Timber Lodge Steakhouse, Inc.*,[4] in which the debtor/tenant rejected a restaurant lease and the landlord later sold the property. The landlord cited multiple cases holding that a landlord has no duty to attempt to re-let leased premises following the tenant's abandonment. The landlord then argued Minnesota law did not require the landlord to mitigate its damages and, therefore, the sale should not reduce the landlord's rejection damages claim. The Court found that while a landlord has no duty to mitigate following a tenant's abandonment, after *termination* of a lease, a landlord does have a duty to mitigate. The Court then held the sale of the leased property was unequivocal proof that the landlord intended to accept the tenant's surrender. Accordingly, the Court held that the sale of the property terminated the lease and constituted mitigation of the landlord's damages such that the landlord had no right to future lease rejection damages accruing after the sale.

Practice Pointers: In light of *Fly I* and *Timber Lodge Steakhouse*, landlords should fully consider the impact on their rejection damages claim from selling the leased property following a debtor/tenant's rejection of a lease. Conversely, debtor/tenants should be vigilant in checking whether the leased property has been sold before resolving a landlord's lease rejection claim. While the argument could be made that the sales price should be analyzed to determine what future rent stream the sales price reflects, with only that imputed rent stream to be credited against the landlord's future damages claim (prior to application of the statutory cap),[5] recent cases seem to require elimination of the landlord's entire rejection claim to the extent based on rent that would have accrued post-sale.

Additionally, at the outset, landlords may be able to mitigate the risk from a future sale through careful lease drafting. For example, landlords may include in their leases language such as "notwithstanding anything contained in this Lease to the contrary, the sale of the Premises by Landlord shall not constitute Landlord's acceptance of Tenant's abandonment of the Premises or rejection of the Lease or in any way impair Landlord's rights upon Tenant's default, including, without limitation, Landlord's right to damages." Such language should express the unequivocal

---

[4] 377 B.R. 604 (Bankr. D. Minn. 2007).

[5] See In re Ames Dept. Stores, Inc., 173 B.R. 80, 82 (Bankr. S.D.N.Y. 1994) (applying the statutory cap to limit landlord's rejection damages claim).

intent of the parties that the landlord's post-rejection sale of the premises would not constitute an acceptance of the tenant's abandonment. Such language should, therefore, decrease the likelihood that when analyzing the parties' conduct in hindsight, a bankruptcy court would disallow the landlord's rejection claim based on post-sale rent accruals.

Types of Claims Covered by the Section 502(b)(6) Damages Cap

Section 502(b)(6) of the Bankruptcy Code limits the amount of a landlord's claim for future damages "resulting from the termination of a lease of real property" to between one and three years' rent, depending on the remaining term of the lease. In most previous cases, courts had found the statutory cap covered all damages under a lease because rejection results in a comprehensive breach of a lease.[6] Nonetheless, the first time the issue was considered at the Circuit Court level, in *Saddleback Valley Community Church v. El Toro Materials Company, Inc. (In re El Toro Materials Company, Inc.),*[7] the Ninth Circuit found the statutory cap does *not* apply to a "tort-like" claim based on physical damages to the leased premises. In *El Toro*, the debtor/tenant, a mining company, left one million tons of wet clay "goo" on the leased property following the debtor/tenant's rejection of its lease. The landlord sought $23 million in damages based on the cost of removal. The debtor/tenant argued that the statutory damages cap applied to the landlord's claim because the condition in which the tenant left the leased premises violated covenants in the lease, which would have reduced the landlord's entire claim to approximately $336,000.

The Ninth Circuit, however, held the statutory damages cap applies only to damages based on the landlord's loss of future rental income, not to tort-like claims. The Ninth Circuit distinguished rent damages from tort damages because the statutory cap formula is calculated based on the remaining lease rent. Thus, the Ninth Circuit reasoned that it "made sense" that the cap did not cover collateral damages bearing at most a weak correlation to the amount of future rent due under the rejected lease.[8] The Ninth Circuit found additional support for its holding in the plain language of section 502(b)(6), which applies to damages "resulting from" lease rejection. In effect, the landlord's claims for waste, nuisance, and trespass did not "result from" lease rejection, but rather from the debtor/tenant's leaving a mess. The Ninth Circuit articulated the following test for whether damages "result from" rejection of the lease: "[a]ssuming 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?" The Ninth Circuit also found that policy concerns favored not applying the statutory damages cap to non-rent damages because: (a) that result avoided giving a debtor/tenant a "perverse incentive"[9] to reject otherwise desirable

---

6 See, e.g., Kuske v. McSheridan (In re McSheridan), 184 B.R. 91, 102 (B.A.P. 9th Cir. 1995) ("[R]ejection 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.").

7 504 F.3d 978 (9th Cir. 2007), cert. denied, 2008 U.S. LEXIS 3140 (U.S. Apr. 14, 2008).

8 El Toro, 504 F.3d at 980.

9 Id. at 981.

leases in order to reduce overall exposure to liability, particularly if the tenant had damaged the leased property; and (b) extending the cap to collateral damages would eliminate any incentive for a debtor/tenant not to damage the leased premises because the tenant would know it could incur no liability in excess of the statutory cap.

Practice Pointers: There will be a new level of uncertainty regarding calculation of lease rejection damages because *El Toro* is inconsistent with many prior cases. Hence, debtor/tenants and landlords may have difficulty determining which damages will be subject to the statutory cap and should consider the applicable jurisdiction when making that evaluation. A key battle line will be drawn over whether or not "tort-like" damages are deemed to arise from rejection of a lease because the claims duplicate a claim based on a breached lease covenant.

A debtor/tenant's prerejection planning also could be impacted. For example, a debtor/tenant's belief that damages are rent-like could be costly if after rejection, a court determines such damages are not subject to the statutory cap. Moreover, there is a risk a debtor/tenant planning on rejecting a lease, but fearing uncapped collateral damage liability, might expend estate resources to repair damage to leased property, effectively incurring some cure costs despite not assuming the lease. Nevertheless, such risks seem limited because any lease rejection claim typically is worth pennies on the dollar, while 100 cent dollars must be expended to make repairs.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Alan J. Lipkin (212-728-8240, alipkin@willkie.com) or the attorney with whom you regularly work.

This memorandum was authored by Alan J. Lipkin and Andrew D. Sorkin.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

April 30, 2008