If the Cap Fits: Landlord Claims for Breaches of Repair and Maintenance Covenants in Bankruptcy

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Section 502(b)(6) of the Bankruptcy Code caps claims asserted by a landlord against a debtor-tenant’s estate. There is little disagreement among courts that § 502(b)(6) applies to limit claims for future amounts due under the terms of a lease. There is, however, a split of authority on § 502(b)(6)’s applicability to claims resulting from the debtor’s pre-petition breach of non-monetary covenants in a lease, such as covenants to maintain and repair the leasehold premises. The issue is of major importance to debtors and landlords alike given the prevalence of such covenants in commercial real estate leases. This article examines the split, the two most recent cases on the subject, and aspects of the debate that have previously been left unexplored.

*Overview of § 502(b)(6)*

Under 11 U.S.C. § 365(a), a debtor may reject burdensome contracts and leases.¹ Rejection of a contract or lease results in a breach of the lease or contract as of the day prior to the bankruptcy filing and allows a landlord to assert a claim for damages against the debtor-tenant’s estate.² Section 502(b)(6), however, caps claims asserted by a landlord against a debtor-tenant’s estate. Specifically, § 502(b)(6) provides that a claim of a lessor for “damages resulting from the termination of a lease of real property” will not be allowed in excess of: (i) the rent reserved by the lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease, following the earlier of the date of the filing of the bankruptcy petition and the date on which the lessor repossessed or the lessee surrendered the leased property (§ 502(b)(6)(A)); plus (ii) any “unpaid rent” due under the lease, without acceleration, as of the earlier of the date of the lessor’s repossession or the lessee’s surrender of the leased premises (§ 502(b)(6)(B)).³

*The Split: Applicability of § 502(b)(6) to Repair and Maintenance Damages*

Upon a debtor-tenant’s rejection of its lease, landlords often find themselves with significant claims related to the debtor-tenant’s breach of non-monetary covenants in the lease, including damages resulting from the pre-petition breach of repair and maintenance covenants. Courts, however, are divided as to whether § 502(b)(6) applies to such damages. If § 502(b)(6) applies to such damages, they are aggregated with the claim for future rent and capped. If, on the other hand, § 502(b)(6) does not apply, then the landlord will have a separate uncapped claim for such damages.

On the one hand, a number of courts addressing the issue have held that § 502(b)(6) does not apply to claims for breach of repair and maintenance covenants.⁴ These courts reason that such claims do
not fall within the scope of § 502(b)(6) because they are not claims “resulting from the termination of a lease”; rather, they are claims wholly independent of termination. For example, in In re Bob’s Sea Ray Boats, Inc., the United States Bankruptcy Court for the District of North Dakota stated that: “[t]he statute applies only to the time period following termination . . . and only includes damages anticipated to result from a tenant’s failure to fill out the lease team. It does not address damages wholly collateral to the termination event.”

Similarly, the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division, in In re Atlantic Container Corp., held that “§ 502(b)(6) is intended to limit only those damages which the lessor would have avoided but for the lease termination.” These courts further reason that, through § 502(b)(6), Congress was only intending to limit future rent claims on the basis that a landlord is different from other creditors in that it will receive back its property and would therefore obtain a windfall upon re-letting the premises absent a cap.

On the other hand, a number of courts have also held that claims for a debtor-tenant’s breach of repair and maintenance obligations are capped by § 502(b)(6). These courts generally reason that termination of a lease effectuates a breach of the lease and all of its covenants, including those for repair and maintenance. For example, the United States Bankruptcy Court for the Western District of Texas in In re Mr. Gatti’s, Inc. concluded that “rejection effectuates a breach of each of the lease covenants as shown by § 365(g) and that breach is what authorizes a landlord to file a proof of claim for damages.” Likewise, the United States Bankruptcy Appellate Panel of the Ninth Circuit in Kuske v. McSheridan (In re McSheridan) held that a debtor-tenant’s “rejection of the lease results in the breach of each and every provision of the lease, including covenants, and [s]ection 502(b)(6) is intended to limit the lessor’s damages resulting from that rejection.”

Courts holding that § 502(b)(6) caps damages resulting from breaches of repair and maintenance covenants also find support in the legislative history. These courts have determined that in adopting § 502(b)(6), Congress and the Commission on the Bankruptcy Laws of the United States intended no substantive changes from § 63(a)(9) of the Bankruptcy Act, the direct predecessor provision to § 502(b)(6) of the Bankruptcy Code. Section 63(a)(9) provided that “the claim of a landlord for damages 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 in no event be allowed in an amount exceeding [the statutory cap]”.

Accordingly, these courts have found that the legislative history and the language of § 502(b)(6)’s predecessor provision shows that Congress intended § 502(b)(6) to cover a landlord’s total damages, including those resulting from breaches of repair and maintenance covenants.

The two most recent courts to address the issue are the United States Bankruptcy Court for the District of Delaware and the United States Court of Appeals for the Ninth Circuit. In In re Foamex Int’l, Inc., the Delaware bankruptcy court held that a landlord is entitled to a single claim for all lease termination damages, including pre-petition damages related to breaches of repair and maintenance covenants under a lease, and that claim is capped by § 502(b)(6). The court was guided heavily by the analyses of earlier cases, most notably In re McSheridan. The court also relied on a United States Court of Appeals for the Third Circuit decision, First Bank Nat’l Ass’n v. Federal Deposit Insurance Corp., that adopted similar reasoning to determine that a provision of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), which was modeled after § 502(b)(6) of the Bankruptcy Code, governs the trustee’s overall liability when it repudiates a lease.

Shortly after the Foamex decision, the Ninth Circuit issued a decision on the scope of § 502(b)(6) in Saddleback Valley Community Church v. El Toro Materials Company, Inc. (In re El Toro Materials Company, Inc.). In a set of particularly egregious
facts, the creditor-landlord, a community church, asserted a claim of $23 million in damages for the
cost of addressing the clean-up of approximately one million tons of wet clay goo, mining equipment, and
other materials that the debtor-tenant allegedly left on the leased property after rejection of the lease.\textsuperscript{17} The debtor-tenant submitted that any damages asserted by the creditor-landlord were subject to § 502(b)(6).\textsuperscript{18}

Ultimately, the Ninth Circuit found that the damage claim should not be capped by § 502(b)(6). It expressed concern that “extending the cap to cover any collateral damage to the premises” would allow even intentional torts to go unpunished under the cover of the statutory cap.\textsuperscript{19} It distinguished those claims that are truly grounded in the landlord-tenant relationship, which are to be capped, from those claims for “collateral damage” that move beyond the confines of that relationship. The Ninth Circuit stated that, “to the extent that [In re] McSheridan holds section 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant’s failure to complete a lease term, it is overruled.”\textsuperscript{20} The Ninth Circuit arguably did not intend to mark a sea change in the case law surrounding §502(b)(6), given that it remarked that “[a]s the tort claims at issue here are not based on a failure to perform routine maintenance, we do not address the propriety of that [aspect of the In re McSheridan] holding.”\textsuperscript{21} Nevertheless, some commentators have read In re El Toro as overruling In re McSheridan’s expansive application of the § 502(b)(6) cap.\textsuperscript{22}

\textit{Which Is the Better View?}

As indicated above, courts finding that § 502(b)(6) is not applicable to breaches of repair and maintenance covenants have emphasized the temporal distinction between \textit{pre-rejection} and \textit{post-rejection} claims, finding that the statutory language of § 502(b)(6) is not applicable to pre-rejection claims. This distinction, however, is arguably not all that compelling in light of § 502(b)(6)(B), which provides that a lessor’s statutorily allowed claim includes the backward looking element of “unpaid rent,” in addition to the forward-looking element of “rent reserved” in § 502(b)(6)(A). Namely, Congress drafted a statutory damage cap provision that explicitly covers both the pre-rejection and the post-rejection time frames. If indeed Congress did not mean for the cap to apply to pre-rejection amounts, then there would be no need to include § 502(b)(6)(B). If § 502(b)(6) only capped post-rejection claims, then the landlord would already have a claim for “unpaid rent,” which necessarily accrues prior to a rejection, even without the allowance made by § 502(b)(6)(B). This strongly suggests that courts holding that § 502(b)(6) caps damages resulting from breaches of repair and maintenance covenants reached the correct result. It is, after all, a black letter rule of statutory interpretation that “if possible, a court should construe a statute to avoid rendering any element of it superfluous.”\textsuperscript{23}

\textit{Should Repair and Maintenance Obligations Be Treated as Uncapped “Unpaid Rent” under § 502(b)(6)(B)?}

In \textit{First Bank Nat’l Ass’n}, the Third Circuit, looking to bankruptcy court jurisprudence, concluded that the \textit{FIRREA} term “contractual rent” \textendash\ akin to the \textit{Bankruptcy Code} term “rent reserved” found in § 502(b)(6)(A) \textendash\ refers only to those charges that are “fixed, regular [and] periodic,” and therefore did not encompass the plaintiff’s repair and maintenance claim.\textsuperscript{24} The Third Circuit found that this formulation was appropriate because it effectuated “the purpose of the [FIRREA] statute in giving the [FIRREA] receiver an opportunity to survey the thrift’s situation without being immediately required to decide whether to assume large obligations.”\textsuperscript{25} The Third Circuit, however, went on to establish a broad formulation of the \textit{FIRREA} term “unpaid rent,” holding that it encompassed the plaintiff’s repair and maintenance claims with the practical effect that they were uncapped by 12 U.S.C. § 1831(e)(4).\textsuperscript{26}
The First Bank Nat’l Ass’n decision therefore opens the door for an interesting argument for landlords to advance in jurisdictions in which courts have concluded that § 502(b)(6) is applicable to breaches of repair and maintenance covenants – namely that damages for breaches of repair and maintenance covenants should be treated as uncapped “unpaid” rent under § 502(b)(6)(B). Curiously, the landlord in In re Foamex never raised the argument and, consequently, the In re Foamex court never addressed the issue. Such an argument, however, would face strong counterarguments. Notably, the Third Circuit did not rely on bankruptcy court jurisprudence in reaching its broad formulation of the FIRREA term “unpaid rent.” The Third Circuit also specifically noted that “the purposes of the Bankruptcy Code are not identical to those of FIRREA” and that “equitable principles developed in the reorganization context cannot simply be grafted onto the national banking statutes.”

The few courts addressing the issue in a chapter 11 context have applied the McSheridan test to determine whether a claim constitutes “unpaid rent” under § 502(b)(6)(B). For example, at issue in In re Edwards Theaters was the debtor-tenant’s failure to comply with its obligation to construct a building on the leased premises. The United States Bankruptcy Court for the Central District of California ruled that the McSheridan test was appropriate in determining both “rent reserved” and “unpaid rent” and held that, “[i]f the purpose behind § 502(b)(6) is to be achieved, a restrictive view of what constitutes rent should apply to both subsections.” Accordingly, because breaches of repair and maintenance obligations are neither related to the value of the property nor fixed, regular, or periodic charges, they should not be included in determining “unpaid rent” under § 502(b)(6)(B).

Further strengthening such a result is that Congress used the same term “rent” in drafting §§ 502(b)(6)(A) and (B). As such, courts have appropriately concluded that the determinations of “rent” for the purposes of subsections (A) and (B) should be governed by the same standard. A proper reading of the interplay between subsections (A) and (B) is that § 502(b)(6)(A) concerns forward looking rent while § 502(b)(6)(B) concerns backward looking rent.

Conclusion

In light of the case law discussed above, whether § 502(b)(6) applies to repair and maintenance claims is an open question. It is, however, the authors’ view that courts finding that § 502(b)(6) is applicable to repair and maintenance claims reached the correct result – particularly in light of the fact that to hold otherwise would render § 502(b)(6)(B) superfluous. It is also the authors’ view that such claims should not constitute uncapped “unpaid rent” under § 502(b)(6)(B).

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bankruptcy, and the unexpired term in no way really benefits the assets of the bankrupt’s estate.


9 162 B.R. at 1013.

10 184 B.R. at 102.

11 See, e.g., McSheridan, 184 B.R. at 102; Mr. Gatti’s, Inc., 162 B.R. at 1013; Storage Technology Corp., 77 B.R. at 825; see also H.R. Rep. No. 95-595, at 353-54 (1977), reprinted in 1978 U.S.C.C.A.N. 5963,6309-10; S. Rep. No. 95-989, at 63-64 (1978), reprinted in U.S.C.C.A.N. 5787, 5849-50 (stating that the new § 502(b)(6) cap, “derived from current law, limits the damages allowable to a landlord of the debtor . . . Moreover, his allowed claim is for his total damages as limited by [the cap].”)


14 Id. (“McSheridan convincingly and firmly concluded that ‘rejection of the lease results in the breach of all of the lease provisions, including covenants and [s]ection 502(b)(6) is intended to limit the lessor’s damages resulting from the rejections.’”) (internal citations omitted).

15 Id. at 389 and 393 (citing First Bank Nat’l Ass’n v. FDIC, 79 F.3d 362 (3d Cir. 1996)).

16 504 F.3d 978 (9th Cir. 2007).

17 Id. at 979.

18 Id.

19 Id. at 981.

20 Id. at 981-82.

21 Id. at 982 n.8.


23 First Bank Nat’l Ass’n v. FDIC, 79 F.3d at 367 (citing United Steelworkers of Am. v. North Star Steel Co., 5 F.3d 39, 42 (3d Cir. 1993), cert. denied, 510 U.S. 1114 (1994)); see also Raven Coal Corp. v. Absher, 153 Va. 332, 335 (1929) (“A fundamental rule of statutory construction requires that every part of a statute be presumed to have some effect, and not be treated as meaningless unless absolutely necessary.”). Surprisingly, no courts examining § 502(b)(6)’s applicability to repair and maintenance claims appear to have grappled with this issue. When faced with a similar question of statutory interpretation in First Bank Nat’l Ass’n, however, the Third Circuit disagreed with a landlord’s argument that such damages are not subject to the statutory cap, noting that, subsection (e)(4)(B)(iii) states that when the receiver disaffirms a lease, the lessor shall “have a claim for any unpaid rent . . . due as of the date of the appointment.” Such unpaid rent is not a claim that stems from the disaffirmance or repudiation of the lease. Consequently, if subsection (e)(4)(a) excluded only claims arising from the disaffirmance of the lease, subsection (e)(4)(B)(iii) would be superfluous, as the lessor would have a claim for unpaid rent as of the date of the appointment of the receiver without regard for disaffirmance. First Bank Nat’l Ass’n v. FDIC, 79 F.3d at 367. The Third Circuit determined that such an interpretation would be unacceptable and rejected the landlord’s limited reading of the statute. Id.

24 Id. at 369.

25 Id. at 368.

26 Id.

27 Id.

28 Id. at 369 (citing Corbin v. Federal Reserve Bank, 629 F.2d 233, 236 (2d Cir. 1980)).

29 In re McSheridan set forth a widely adopted three-prong test to determine whether a charge constitutes “rent reserved” under § 502(b)(6)(A): the charge must: (i) be designated as “rent” or “additional rent” in the lease; or (b) be provided as the tenant’s/lessor’s obligation in the lease; (ii) be related to the value of the property or the lease thereon; and (iii) be properly classifiable as rent because it is a fixed, regular, or periodic charge. See McSheridan, 184 B.R. at 99-100.

30 See In re Edwards Theatres Circuit Inc., 281 B.R. 675, 683 (Bankr. C.D. Cal. 2002) (stating that the McSheridan test applies to both § 502(b)(6)(A) and (B)); In re Smith, 249 B.R. 328, 337 (Bankr. S.D. Ga. 2000) (adopting the McSheridan test for determination of rent under §§ 502(b)(6)(A) and (B)).


32 Id. at 684.

33 See 368 B.R. at 392; Edwards Theaters, 281 B.R. at 684.


35 See In re Premier Entertainment Biloxi, LLC, 413 B.R. 370, 377 (Bankr. S.D. Miss. 2009); Edwards, 281 B.R. at 684; Smith, 249 B.R. at 337.

36 See Premier Entertainment Biloxi, LLC, 413 B.R. at 377; Edwards, 281 B.R. at 684; Smith, 249 B.R. at 337. In contrast, the FIRREA terms “contractual rent” and
“unpaid rent” under 12 U.S.C. § 1821(e)(4) both refer to periods before the receiver's repudiation of the lease. First Bank Nat'l Ass'n, 79 F.3d at 368 ("Thus, section 1821(e)(4)(B) provides that a claimant has the right to "unpaid rent" due at the date of appointment of the receiver, and "contractual rent" accruing before the latter of the date that the notice of disaffirmance or repudiation is mailed or the date it becomes effective"). Consequently, the court in First Bank Nat'l Ass'n may have felt compelled to interpret them as having different meanings, stating: "'Rent,' paid or unpaid, clearly encompasses contractual rent. Yet 'contractual rent' must include a different category of claims than 'rent' generally. If it did not, there would have been no reason for Congress to distinguish between 'unpaid' and 'contractual' rent in section 1821(e)(4)(B) or, at least, Congress would have required the FDIC to pay 'unpaid contractual rent' rather than 'unpaid rent' due as of the date of the appointment of the receiver." Id. at n.5.