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Ninth Circuit Limits Application Of Bankruptcy Cap Upon Lease Termination

Saddleback Valley Community Church v. El Toro Materials Company, Inc.

2007 U.S. App. LEXIS 22991 (October 1, 2007)

In a decision that should provide comfort to landlords confronting insolvent tenants, the Ninth Circuit recently ruled that the Bankruptcy Code's limitation on the amount of damages a landlord is entitled to recover upon termination of a lease does not limit the landlord's right to recover damages which are not based upon the loss of future rental income.

Before the enactment of the Bankruptcy Act of 1934, landlords were precluded from recovering any lost rent upon the rejection of a lease by a bankrupt tenant. *Manhattan Props., Inc. v. Irving Trust Co.*, 291 U.S. 320 (1934). However, to address the dilemma of landlords having to re-lease property in a depressed market and the potential devastation to the bankrupt estate by allowing a claim for future rent, the compromise included in the Bankruptcy Act of 1934 entitled a landlord to recover a claim for back rent to the date of abandonment plus one year of future rent, upon termination of a lease in bankruptcy. *Oldden v. Tonto Realty Corp.* 143 R. 2d 916, 920-21 (2d Cir. 1944).

Despite significant modifications to the Bankruptcy Act in 1978 and again in 1995, the concept of a limit on landlord's damages has changed little. Section 502(b)(6) now provides a cap on damages that a landlord can recover for damages upon a lease termination in bankruptcy to "the greater of one year or 15 percent, not to exceed three years, of the remaining term of the lease." 11 U.S.C. § 502(b)(6).

In *Saddleback Valley Community Church*, the landlord church brought an adversary claim against its tenant, a mining company, seeking recovery of \$23,000,000 in costs the landlord incurred in removing a million tons of sludge and mining equipment from its property following a rejection of the lease in bankruptcy. The church appealed a bankruptcy appellate panel decision affirming the application of the cap to its claim to the Ninth Circuit.

Reviewing the legislative history of the limitation of landlord's damages, the 9th Circuit concluded that since the "damages cap was 'designed to compensate the landlord for his loss while not permitting a claims so large (based on a long-term

lease) as to prevent other general unsecured creditors from recovering a dividend from the estate'" (quoting from S. Rep. No. 95-989 at 63 (1978) *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5849, it should not be applied to defeat a claim for what the court describes as "collateral damages." Moved by the fact that the amount of the damage claim was \$23,000,000 and the amount of the monthly rent paid under the lease was \$28,000, the court determined that applying the cap to such collateral damages was inconsistent with the goal of the bankruptcy law to entitle creditors to "an aliquot share of the estate to settle their debts." Noting that the claim presented by the landlord would have been applicable had the lease been assumed, rather than rejected, the court concluded that the damage for which recovery was sought arose from tenant's conduct on the leased premises, not from the termination of the lease.

The case was remanded to the bankruptcy court for a determination of the merits of landlord's claims. In the course of its opinion, the court expressly overruled *Kuske v. McSheridan (In re McSheridan)* 184 B.R. 91 (B.A.P. 9th Cir. 1995) "[t]o the extent *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...."

While this is a new ruling that will have to be further developed and interpreted by subsequent courts, it does open the field for landlords who can now claim tort damages and hopefully not have those claims limited by the Bankruptcy Code's cap on landlord claims for lease rejections.

ABOUT THE AUTHORS

Alfred M. Clark, III and Joshua D. Wayser are partners in Locke Lord Bissell & Liddell LLP's Los Angeles office. They represent investors, landowners, commercial users, and institutional lenders in a wide variety of real estate transactions and disputes.