

Client Alert

Financial Restructuring Practice Group

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Ninth Circuit Rules Lease Damages Cap Does Not Apply to Damages Independent of Termination

On December 29, 2016, the U.S. Court of Appeals for the Ninth Circuit (the “Court”) issued an opinion, holding that the statutory cap on a landlord’s damages claim in a bankruptcy case applies *only* to claims resulting directly from the termination of a lease, including pre-petition lease terminations.¹ Splitting with lower courts in other jurisdictions,² landlords in the Ninth Circuit may assert uncapped claims where their damages are “independent of termination,” including arbitration and attorneys’ fees and damages arising from tort claims.

Background and the Bankruptcy Court Decision

The debtors were tenants of two commercial properties in California. The debtors stopped paying rent and eventually vacated the premises. The respective landlords sued for breach of both leases and the dispute was resolved through arbitration. The landlords prevailed in the arbitration and were awarded more than \$1.3 million for past and future rent along with attorneys’ fees and arbitration fees amounting to nearly \$200,000.

Thereafter, the debtors filed for chapter 11 bankruptcy protection. The landlords filed proofs of claim in the bankruptcy case for the amount of the arbitration award. The debtors objected, arguing that the entire arbitral award, including attorneys’ fees and arbitration fees, should be limited by the damages cap contained in 11 U.S.C. § 502(b)(6), which provides that landlords’ “claim[s] . . . for damages resulting from the termination of a lease” are capped at the sum of all outstanding rent due and the greater of one year of remaining rent or 15% of the remaining term (not to exceed three years).³ The landlords argued that the cap should apply only to past due and future rent but not to the fee award. The bankruptcy court agreed with the landlords and allowed their claims in the amount of the arbitration award for past and future rent (as limited by the statutory cap), plus the entire uncapped claim for arbitration fees and attorneys’ fees. The district court affirmed.

Decision on Appeal

On appeal the sole issue in dispute was the legal question of whether the arbitration and attorneys’ fees are subject to the statutory cap. In a unanimous panel decision, the Court, relying on its 2007 *El Toro*⁴ decision, held that “damages other than those based on loss of future rent are not subject to the

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cap.” *El Toro*, however, did not address the issue of capping claims for associated attorneys’ fees. Building on *El Toro*, the Court adopted the Eighth Circuit Bankruptcy Appellate Panel’s test from *In re Wigley*.⁵ The test posits: “Assuming that all other conditions remain constant, would the landlord have the same claim against the tenant had the lease not been terminated?”⁶

Applying that test, the Court concluded that the arbitration and attorneys’ fees attributable to litigating the landlord’s claims for future rent were capped because the claim would not have arisen if the debtors had not terminated the leases. However, the Court held that the arbitration award also included damages for past rent, which the landlord could claim independent of the pre-petition lease termination, and thus, any arbitration or attorneys’ fees attributable to the past rent due were not statutorily capped. The Court remanded, ordering the district court to categorize and then apportion the claim award as either past due rent claims (which are not subject to the cap), and lease termination claims (which are subject to the cap).

Conclusion and Lessons Learned

At least in the Ninth Circuit, the Bankruptcy Code’s cap on lease termination damages may not apply to arbitration and attorneys’ fees and other damages that are independent of lease termination or rejection, such as damages arising from tort claims against a tenant. To date, other Courts of Appeal have not squarely addressed these issues, although decisions from lower courts in other jurisdictions have trended toward adopting reasoning similar to the Ninth Circuit.⁷ The Ninth Circuit’s decision provides landlords facing similar objections to their bankruptcy claims in other jurisdictions arguments as to why their damages unrelated to the rejection and termination of the lease should not be capped.

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¹ *Kupfer v. Salma (In re Kupfer)*, Case No. 14-16697 (9th Cir. Dec. 29, 2016).

² *See, e.g., In re Storage Tech. Corp.*, 77 B.R. 824 (Bankr. D. Colo. 1986); *In re Mr. Gatti's Inc.*, 162 B.R. 1004 (Bankr. W.D. Tex. 1994).

³ 11 U.S.C. § 502(b)(6).

⁴ *Saddleback Valley Cmty. Church v. El Toro Materials Co. (In re El Toro Materials Co.)*, 504 F.3d 978 (9th Cir. 2007).

⁵ *Lariat Co's v. Wigley (In re Wigley)*, 533 B.R. 267, 270-71(B.A.P. 8th Cir. 2015).

⁶ *In re Kupfer*, Case No. 14-16697, at *4 (citing *El Toro*, 504 F.3d at 981).

⁷ *See, e.g., In re Ancona*, Case No. 14-10532, 2016 WL 1399265 (Bankr. S.D.N.Y. Apr. 6, 2016); *In re Filene's Basement, LLC*, No. 11-13511, 2015 Bankr. LEXIS 1350, at *32 (Bankr. Del. Apr. 16, 2015).