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RENT CLAIMS AND SECURITY DEPOSITS IN BANKRUPTCY†

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Rent claims in bankruptcy have always presented perplexing problems, and always will. Not only have the courts had trouble with the question of the provability of such claims, but they constantly have had a difficult time determining the amount of provable claims.

In discussing these problems some limitations must be imposed. Anticipatory breaches of lease contracts have for centuries been treated differently from anticipatory breaches of other contracts; but intriguing as this is from an historic standpoint, that phase of the subject will not be reviewed in this article. Nor will consideration be given to landlords' liens, the priorities of rent claims and other closely allied matters. Whether an action to recover a deposit made for security may take the form of a summary proceeding, or whether a plenary action is required, also poses problems that will not be touched upon. Finally, the rights of parties to real estate leases are in general governed by state law unless there are contrary provisions in the Bankruptcy Act or other federal law.¹ It is not feasible in any limited consideration of rent claims to study the extent to which state law has affected the decisions in bankruptcy cases.

This article, then, will be limited to a discussion of (1) the provability, both before and after the 1934 amendment, of claims for future rent and for breach of covenants to pay rent, (2) the termination of leases due to bankruptcy, (3) the calculation of the amount for which landlords' claims for anticipatory breach should be allowed, and (4) the disposition after bankruptcy of deposits made as security for the performance of lease covenants.

†This article is a revised draft of a paper delivered at the Annual Conference of Referees in Bankruptcy, Birmingham, Alabama, October 14, 1952.

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1. *In re* Burke, 76 F. Supp. 5 (S.D. Cal. 1948); *Urban Properties v. Benson*,

116 B. 2d 1321 (9th Cir. 1949).

I. PROVABILITY OF CLAIMS FOR FUTURE RENT

A. *Prior to 1934 Amendment*

The Bankruptcy Act as enacted in 1898 contained no provision for the proving of claims resulting from a breach of a covenant to pay rent. Some early cases held that leases for a term were terminated by an adjudication of the lessee during the term, and that the landlord had no provable claim for rent which would have accrued under the lease after adjudication;² and this was held true even though the bankrupt had executed notes for rent due for months after the adjudication.³ It was not long, however, before the courts reached the conclusion that since a landlord's claim was not provable, the debtor could not receive a discharge; that the lease was not terminated *ipso facto* by bankruptcy, and that unless the lessor himself terminated the lease, he continued to have claims, accruing month by month, against the bankrupt for rent accruing under the lease; that is, unless the trustee elected to retain the lease as an asset of the estate.⁴

The decisions to the effect that the claims were not provable were based on the theory that they were too contingent, either because of the uncertainty existing at the time of bankruptcy that the lessor would re-enter, or because of the doubt of the existence of loss in the event that he should.

Where a lease did not by its express terms terminate the tenancy upon bankruptcy or specifically prohibit the acquisition of the lessee's rights by the trustee in bankruptcy of the lessee, the lessee's leasehold interest passed to the trustee if he elected to accept it.⁵ A disclaimer by a trustee did not terminate the lease nor *ipso facto* effect a surrender; the rejection left the lease in full force between the landlord and the insolvent tenant.⁶

Where a lease provides that it shall be personal to the lessee, and shall not inure to the benefit of any receiver or trustee in bankruptcy, bankruptcy has been held to terminate all obligations for future rent;⁷ and since a lease containing such a clause terminates *ipso facto* upon bankruptcy, there is no claim remaining, and nothing provable.

2. *In re* Jefferson, 93 Fed. 948 (D. Ky. 1899).

3. *In re* Hays, Foster & Ward Co., 117 Fed. 879 (D. Ky. 1902).

4. Burns Trading Co. v. Welborn, 81 F. 2d 691 (10th Cir. 1936), *cert. den.* 298 U.S. 672 (1936); *In re* Hook, 25 F. 2d 498 (D.C. Md. 1928); *In re* Sherwoods, 210 Fed. 754 (2d Cir. 1913); *In re* Roth & Appel, 181 Fed. 667 (2d Cir. 1910); *Watson v. Merrill*, 136 Fed. 359 (8th Cir. 1905).

5. Burns Trading Co. v. Welborn, 81 F. 2d 691 (10th Cir. 1936), *cert. den.* 298 U.S. 672 (1936); *In re* Sherwoods, 210 Fed. 754 (2d Cir. 1913).

6. *Rosenblum v. Uber*, 256 Fed. 584 (3rd Cir. 1919).

7. *Jandrew v. Bouche*, 29 F. 2d 346 (5th Cir. 1928).

A general covenant in a lease prohibiting an assignment does not preclude a transfer of the lessee's rights to a trustee in bankruptcy, such transfer being regarded as one by operation of law.⁸ However, a covenant may be drawn so as expressly to prohibit such a transfer.⁹ A lease, being property *cum onere*, does not pass to a trustee unless he adopts it;¹⁰ but when by affirmative act he does adopt it, such adoption relates back to the filing of the petition.¹¹

The right of the landlord to hold the tenant for rentals accruing after bankruptcy was usually a worthless one, because immediate and satisfactory rehabilitation of the bankrupt's financial status would be necessary to give value to such a right. Of course re-entry by the landlord would relieve the tenant from liability for future rents. Landlords seeking to protect themselves inserted provisions in their leases providing them with an optional right of re-entry, and in many cases they included covenants for indemnity for all loss of future rents occasioned by bankruptcy. The courts held that claims based upon such covenants were, like claims for rent, contingent and incapable of proof, there being an uncertainty at the time of bankruptcy as to whether the option would be exercised.

In 1933 Congress by Act of March 3 enacted Provisions for the Relief of Debtors.¹² It provided in part for a new Section 74, covering Compositions and Extensions, which provided that

"The term 'creditor' shall include for the purposes of an extension proposal under this section all holders of claims of whatever character against the debtor or his property including a claim for future rent, whether or not such claims would otherwise constitute provable claims under this Act. A claim for future rent shall constitute a provable debt and shall be liquidated under section 63(b) of this Act."

*Manhattan Properties v. Irving Trust Co.*¹³ reached the Supreme Court for decision in early 1934. In the words of Justice Roberts, it presented the question whether a landlord might make proof in bankruptcy for loss of

8. *In re Wil-Low Cafeterias*, 111 F. 2d 83 (2d Cir. 1940); *Gazley v. Williams*, 210 U.S. 41, 52 L.Ed. 950, 28 Sup. Ct. 687 (1908).

9. *Jandrew v. Bouche*, 29 F. 2d 346 (5th Cir. 1928).

10. *Palmer v. Palmer*, 104 F. 2d 161 (2d Cir. 1939), *cert. den.* 308 U.S. 590 (1939).

11. *Fletcher v. Surprise*, 180 F. 2d 669 (7th Cir. 1950); *In re Central Georgia Ry.*, 47 F. Supp. 786 (S.D. Ga. 1942).

12. 47 STAT. 1467, c. 204, U.S.C.A. § 202, sub. a. See also § 77(b) respecting railroad reorganizations (47 STAT. 1475, c. 204), considered in *Connecticut Ry. & L. Co. v. Palmer*, 305 U.S. 493, 83 L. Ed. 309, 59 Sup. Ct. 316 (1939).

13. 291 U.S. 320, 78 L.Ed. 824, 54 Sup. Ct. 385 (1934).

rents payable in the future where a claim is founded upon the bankrupt's covenant to pay rent, and, in the alternative, upon his breach of a covenant that in the event of bankruptcy, the landlord may re-enter, and if he does, the tenant will indemnify him against loss of rents for the remainder of the term. The Court, following the weight of authority of the lower courts, held that a claim for future rents was not provable. With reference to the contention that the provisions of the Act of March 3, 1933, were applicable, the decision pointed out that Congress had not amended Section 63(a) of the Act, as it might have done, and that the provisions above quoted must be limited to Section 74 cases. Furthermore, it was held that the claim could not rest upon the indemnity covenant of the lease because that made no provision for liquidation of damages. The Court conceded that while there might be some argument that bankruptcy constituted an anticipatory breach of the lease contract, this could not possibly be true of an indemnity covenant; for the lessor "initiates a new contract of indemnity by the affirmative step of re-entry." And this new contract comes into being not by virtue of the bankruptcy proceeding, but by force of the act of re-entry, which must occur at a date subsequent to the filing of the petition.

In the *Manhattan* case, the lessor's re-entry occurred after bankruptcy. *Miller v. Irving Trust Company*¹⁴ involved a lease that contained similar covenants, but the re-entry occurred prior to bankruptcy. The same result was reached.

One device, the so-called *ipso facto* clause, did prove efficacious. Such a clause provided that the very filing of a bankruptcy petition in itself terminated the lease forthwith without notice, and without the exercise of an option. Complementing the *ipso facto* clause, the lease necessarily contained a valid covenant for damages resulting from the breach occasioned by bankruptcy. Of course the termination did not absolve the lessee from obligations incurred prior to the filing of the petition, and of course the *ipso facto* clause was developed to avoid the consequences of the non-provability decisions. Under such a clause, the lease by its terms terminated automatically without action by lessor or lessee upon the filing of a petition, and it follows that no rent could accrue thereafter.

In *Kothe v. Taylor Trust*,¹⁵ the lease under consideration provided that it should terminate upon bankruptcy and that the landlord should be entitled to recover an amount equal to the rent for the remainder of the term.

14. 296 U.S. 256, 80 L.Ed. 211, 56 Sup. Ct. 189 (1936).

15. 280 U.S. 224, 74 L.Ed. 382, 50 Sup. Ct. 142 (1929).

The Supreme Court held that the amount stipulated was so disproportionate to the damages reasonably to be anticipated that it must be considered a penalty and that the covenant would not be enforced. But shortly thereafter the same court had before it a lease containing a covenant for damages under the terms of which the lessor was entitled to recover an amount equal to the rent for the remainder of the term less the fair rental value for such remainder. This covenant was of the same type as that in the *Manhattan Properties* case, but in this case there was an *ipso facto* clause. The Court sustained the lessor's claim as being for liquidated damages, as distinguished from the penalty involved in the *Kothe* case.¹⁶

Claims under *ipso facto* clause leases are not for rent, but for damages, and where the lease is entered into under circumstances which indicate a difficulty of ascertaining actual damages to be suffered in the event of a breach, and are reasonable in their character, they will be regarded claims for liquidated damages and provable.¹⁷

B. After 1934 Amendment

As a result of the *Manhattan Properties* case Congress in 1934 amended the Act by adding an entirely new sub-section, Section 63a (7), which made provision for proving

"Claims for damages respecting executory contracts including future rents whether the bankrupt be an individual or a corporation, but the claim of the landlord for injury resulting from the rejection by a trustee of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such a lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises plus an amount equal to the unpaid rent accrued up to said date . . ."¹⁸

The object and effect of the new sub-section was to change a contingent, unliquidated, unprovable claim into a provable claim, albeit a limited one, and to prescribe a rule for its liquidation. It modified the rule that re-entry was necessarily inconsistent with the survival of a claim for future rent.

This 1934 amendment, as amended in certain respects by the Chandler Act,¹⁹ appears today as Section 63a (9).²⁰ The obvious amendment made

16. *Irving Trust Co. v. Percy*, 293 U.S. 307, 78 L.Ed. 379, 56 Sup. Ct. 150 (1934).

17. *In re Owl Drug Co.*, 12 F. Supp. 431 (D. Nev. 1935).

18. Act of June 7, 1934, 48 STAT. 923, 11 U.S.C.A. § 103a(7) (1937).

19. Act of June 22, 1938, 52 STAT. 873.

20. 11 U.S.C. § 103a(9) (1946).

by the Chandler Act was to start the running of the limiting year from the date of the surrender to the landlord or from the date of re-entry, whichever first occurs, but there was no real change in the substance of the law. The Chandler Act also added as a clarifying amendment, Section 63 (3),²¹ which fixed the date of the filing of the petition as the date of the anticipatory breach. Section 202 of present Chapter X²² and Section 353 of present Chapter XI²³ make similar provisions for special proceedings under those chapters, with the noteworthy difference that the claim period limitation in these sections is three years rather than one. Section 77B, enacted by the same legislation as the aforementioned 1934 amendment, had contained a similar provision with a three-year limitation.

Under the 1934 amendment the Supreme Court soon held, in 77B proceedings in the *City Bank* and other cases, that while re-entry and occupation amounts under the law of most states to a complete termination of the leasehold and deprives the lessor of any further rights as such, it does not destroy the provability of a claim for injury due to the rejection of the lease or upon a covenant of indemnity, whether the instrument contains a covenant of indemnity or not.²⁴ The same result was reached in straight bankruptcy proceedings.²⁵ In fact, while the provisions for proving claims under Section 63(a) and under the provisions of the Act relating to corporate reorganization differ in some respects, they are so similar that the decisions in corporate reorganization cases have been regarded as applicable to ordinary bankruptcy proceedings.²⁶

When a lease has been terminated, the 1934 amendment does not permit a claim for future rent as such, but recognizes only a claim for damages on account of the loss of future rents. It has been stated that a landlord cannot have both the premises and a claim for rent for the balance of the term,²⁷ but the rule that the termination of a lease, either by virtue of an

21. 11 U.S.C. § 103(c) (1940).

22. 11 U.S.C. § 602 (1940).

23. 11 U.S.C. § 752 (1940).

24. *City Bank Farmers Trust Company v. Irving Trust Co.*, 299 U.S. 433, 81 L.Ed. 324, 57 Sup. Ct. 292 (1937); *Schwartz v. Irving Trust Co.*, 299 U.S. 456, 81 L.Ed. 348, 57 Sup. Ct. 303 (1937); *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 81 L.Ed. 340, 57 Sup. Ct. 298 (1937).

25. *Rocky Mountain Fuel Co. v. Whiteside*, 110 F. 2d 778 (10th Cir. 1940); *In re Benguiat*, 20 F. Supp. 504 (S.D. Cal. 1937); *In re Winn Shoe Co.*, 87 F. 2d 713 (2d Cir. 1937).

26. *In re Jas. Butler Grocery Co.*, 22 F. Supp. 995 (E. D. N.Y. 1938); *In re Winn Shoe Co.*, 87 F. 2d 713 (2d Cir. 1937).

27. *In re Mt. Holly Paper Co.*, 110 F. 2d 220 (3rd Cir. 1940).

ipso facto clause, or by reason of the landlord's re-entry, eliminates all claims for future rent, is subject to the proviso that the landlord may, by covenant carefully drawn, both retain the property and have a claim for damages for the breach.

Thus the general rule that an adjudication in bankruptcy constitutes an anticipatory breach of an executory contract, remitting claimant to a claim for damages for the breach²⁸ was by the 1934 amendment extended to apply to unexpired leases. This is now specifically stated in Section 63(3)²⁹ of the Act.

The doctrine of the *City Bank* case³⁰ to the effect that a surrender of the premises and re-entry by the landlord does not deprive the latter of a provable claim was held subject to the proviso that if the lease contains a clause stipulating that a transfer by the tenant to the landlord shall terminate the tenant's liability under the lease, then a transfer by the bankruptcy trustee to the lessor's nominee bars the right of the lessor to prove a claim as a result of the trustee's rejection of the lease;³¹ and certainly a lessor who in consideration of a surrender of the lease executes an unqualified release is precluded from asserting subsequently in bankruptcy proceedings a claim for future rent or under an indemnity clause.³² Also, where there was no rejection by the trustees prior to re-entry, as there was in the *City Bank* case, but such rejection was only after the landlord had entered and relet without giving a notice prescribed by the lease, the lease was at an end and no rights were acquired by the landlord by the subsequent rejection by the trustee. The landlord under such circumstances had no provable claim.³³

Some decisions make the observation that the 1934 amendment created no new claim, but merely requires treatment of the adjudication as a breach of covenant and gives a provable claim by virtue of that breach.³⁴ It may be noted, however, that before the 1934 amendment re-entry was held necessary to end the lease, while under the amendment the relation of landlord and

28. *Central Trust Co. v. Chicago Auditorium Ass'n.*, 240 U.S. 581, 60 L.Ed. 811, 36 Sup. Ct. 412 (1916).

29. 11 U.S.C. § 103(c) (1946).

30. *Supra*, note 24.

31. *Meadows v. Irving Trust Co.*, 299 U.S. 464, 81 L.Ed. 353, 57 Sup. Ct. 307 (1937).

32. *Schwartz v. Irving Trust Co.*, 299 U.S. 456, 81 L.Ed. 348, 57 Sup. Ct. 303 (1937).

33. *In re Radio-Keith-Orpheum Corporation*, 91 F. 2d 938 (2d Cir. 1937), *cert. den.* 302 U.S. 748 (1937).

34. *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 81 L.Ed. 324, 57 Sup. Ct. 292 (1937); *Rocky Mountain Fuel Co. v. Whiteside*, 110 F. 2d 778 (10th Cir. 1940).

tenant, subject to certain rights of the trustee, automatically terminates on bankruptcy.³⁵ Or, as one case puts it, the adjudication and the election of the trustee to reject the lease terminates the landlord and tenant relationship.³⁶ But a covenant in the lease giving the lessor the option to terminate the lease in the event of bankruptcy did not of itself, either prior to or after the 1934 amendment, work an automatic forfeiture of the lease; it was not an *ipso facto* clause.³⁷

There was at one time considerable doubt whether notwithstanding Section 63a(9) it would still be possible for a claimant-landlord to rely upon a contractual *ipso facto* termination of the lease and nevertheless claim damages as provided by the covenants of the contract.³⁸ It would seem now that this doubt has been resolved in favor of the landlord.³⁹

By reason of the wording of Section 63a(9), some discussion of the phrase "surrender of the premises" seems necessary. Ordinarily the question of surrender, whether by intention of the parties or by operation of law, is to be determined by the law of the state.⁴⁰ Generally acceptance by the lessor of keys to the premises is not regarded as a surrender, but a substitution of tenants is. The mere rejection of a lease by a bankruptcy trustee or by a debtor-in-possession does not of itself effect a surrender to the landlord, but this simply constitutes an abandonment of a worthless asset. However, an abandonment coupled with an action by the landlord inconsistent with the relationship of landlord and tenant may constitute a surrender.⁴¹ Generally, but not invariably, the making of a new lease is deemed a termination of the old one.⁴² The question may turn on whether the landlord makes the new lease on his own account or on account of the lessee.

It has been held that where a trustee elected to reject a lease, obtained a court order authorizing the rejection, notified the lessor that the trustee surrendered all of his rights in the lease, and put the landlord in a position where he could exercise complete dominion over the property, there was a "surrender of the premises" within the meaning of the Bankruptcy Act even

35. *In re Benguiat*, 20 F. Supp. 504 (S.D. Cal. 1937); *Petition of Colburn*, 16 F. 2d 780 (1st Cir. 1926).

36. *Rocky Mountain Fuel Co. v. Whiteside*, 110 F. 2d 778 (10th Cir. 1940).

37. *In re Benguiat*, 20 F. Supp. 504 (S.D. Cal. 1937).

38. 3 COLLIER, BANKRUPTCY p. 1896 ff. (14th ed. 1941).

39. *Oldden v. Tonto Realty Co.*, 143 F. 2d 916 (2d Cir. 1944).

40. *Creedon v. Lampadusa*, 81 F. Supp. 697 (S.D. N.Y. 1948); *Hotz v. Federal Reserve Bank*, 108 F. 2d 216 (8th Cir. 1939).

41. *Creedon v. Lampadusa*, 81 F. Supp. 697 (S.D. N.Y. 1948); *Hotz v. Federal Reserve Bank*, 108 F. 2d 216 (8th Cir. 1939).

42. *In re Kerr*, 29 F. Supp. 414 (S.D. N.Y. 1939).

though there was not a surrender under the strict law of Landlord and Tenant.⁴³

Following the law of equity receivership cases the courts have decided that if a receiver, a debtor in possession, or a new corporation in a corporate reorganization, does not affirm a lease or assume its obligations but merely adopts it, such party is not liable for rent as the substituted lessee. The liability incurred is only to pay the stipulated rental for the premises so long as they are used, and apparently such party can relieve himself of liability by making an actual bona fide assignment of the lease to a third party.⁴⁴

II. TERMINATION OF LEASES

As indicated above (at note 35), a lease is, under the present Bankruptcy Act, terminated by adjudication of the lessee and election of the trustee to reject even though it contains no provision for termination on bankruptcy. Prior to the passage of the Chandler Act a receiver, trustee, or debtor in possession of a bankrupt or debtor had a reasonable time, subject to the control of the court, within which to assume or reject a lease.⁴⁵ By the provisions of Section 70(b),⁴⁶ enacted as a part of the Chandler Act of 1938, a trustee in bankruptcy within sixty days after the adjudication shall assume or reject unexpired leases of real estate. Any lease not assumed within such time, or such other time as may be fixed by court order, shall be deemed rejected. Under this section, unless a lease shall expressly provide otherwise, a rejection by a trustee of a *lessor* shall not deprive a lessee of his estate. A general covenant against assignment shall not prevent acquisition of a lease by a trustee by operation of law, but an express covenant providing for termination upon bankruptcy is declared enforceable. Except for the sixty day limitation, Section 70(b) is largely declaratory of prior law.

While well-reasoned cases hold that the provisions of Section 70(b), fixing a time limit of sixty days, are in conflict with Sections 116(1) and

43. *In re United Cigar Stores of America*, 86 F. 2d 692 (2d Cir. 1936), *cert. den.* 300 U.S. 679 (1936).

44. *In re Wil-Low Cafeterias*, 111 F. 2d 83 (2d Cir. 1940); *Mohonk Realty Corp. v. Wise Shoe Stores*, 11 F. 2d 287 (2d Cir. 1940), *cert. den.* 311 U.S. 654 (1940); *Hotz v. Federal Reserve Bank*, 108 F. 2d 216 (8th Cir. 1939); *Madden v. LaCofske*, 72 F. 2d 602 (9th Cir. 1934).

45. *Kennedy v. Boston-Continental Nat. Bank*, 11 F. Supp. 611 (D. Mass. 1935), *rev'd on other grounds*, 84 F. 2d 592 (1st Cir. 1936); *Rosenblum v. Uber*, 256 Fed. 584 (3rd Cir. 1919). Prior to 1934, rejection by the trustee did not terminate the lease. See text at note 35, *supra*.

46. 11 U.S.C. § 110(b) (1946).

202 of Chapter X,⁴⁷ in one case the court assumed that this limitation is applicable to reorganization cases.⁴⁸ And in *Finn v. Meighan*⁴⁹ the Supreme Court stated that by Section 102⁵⁰ the provisions of Section 70(b) are made applicable to reorganization proceedings.⁵¹ It must be conceded that in *Finn v. Meighan* the sixty day time limitation of Section 70(b) was not directly involved; although the Court by way of dicta said that it applied.

The question arose in a Chapter X proceeding in the Eighth Circuit. The trustee had made remittances to the owner of the premises for a considerable period of time under orders of court which designated such payments as rent. The court held, however, that since there was no formal adoption within the sixty days limited by Section 70(b) "nor at any subsequent date," the payments were for use and occupation and not for rent, that there was a conclusive statutory presumption that the lease was rejected because it was not adopted within sixty days, and that the court could determine, some years after the proceedings were instituted and after payments of amounts equivalent to rent had been continued, that the value of use and occupation was less than the amount stipulated in the lease.⁵²

In railroad reorganization cases it has been held that a trustee in bankruptcy while determining whether or not to adopt a lease need not pay rent, and the lessor must be content with the value of the use and occupation while he is so determining. The court ordinarily will fix that at the same amount as the rent.⁵³ The power of the trustee to adopt or reject the lease does not effect the continued existence of the lease during the period of reasonable time within which the trustee of a railroad must make up his mind.⁵⁴

It may be noted that Section 70(b) uses the phrase "assume or reject," while the chapter on Railroad Reorganizations uses the words "adoption" and "rejection." The corresponding provisions of Chapter X and XI refer only to the rejection of a lease, without using either "assume" or "adopt" in any form.

An express covenant which authorizes the lessor to terminate the

47. Title Insurance & Guaranty Co. v. Hart, 160 F. 2d 961 (9th Cir. 1947); *In re Childs*, 64 F. Supp. 282 (S.D. N.Y. 1944).

48. Texas & N.O. R.R. v. Phillips, 196 F. 2d 692 (5th Cir. 1952).

49. 325 U.S. 300, 89 L.Ed. 1624, 65 Sup. Ct. 1147 (1945).

50. 11 U.S.C. § 502 (1946).

51. Cf. *McGill v. Sterling Nat. Bank & Trust Co.*, 102 F. Supp. 1011 (S.D. N.Y. 1952).

52. *Wiemeyer v. Koch*, 152 F. 2d 230 (8th Cir. 1945).

53. *Palmer v. Palmer*, 104 F. 2d 161 (2d Cir. 1939), *cert. den.* 308 U.S. 590 (1939).

54. *Johnson v. Kum*, 95 F. 2d 629 (8th Cir. 1938).

lease if a petition to reorganize under the Bankruptcy Act is filed, places upon the courts a duty to enforce it in case such a contingency arises. The question is one of construction of the lease.⁵⁵ Provisions in a lease for the lessor's re-entry in event of the tenant's insolvency, bankruptcy or receivership are valid and must be given effect.⁵⁶ The term "insolvency" is generally interpreted to refer to inability to pay debts as they mature, and an order continuing a debtor in possession is taken to fall within the purview of a covenant authorizing termination by the lessor upon the appointment of a receiver.⁵⁷ This is true even though the lessor by the exercise of his right would make a reorganization impossible.⁵⁸

Thus the policy which prevents pledgees and mortgagees from foreclosing their liens in reorganization cases is not extended to cover situations in bankruptcy reorganizations involving forfeiture clauses of carefully drawn leases.⁵⁹ But where the forfeiture clause of the lease does not clearly give the lessor the right to terminate, the clause will not operate to permit a forfeiture.⁶⁰

Forfeiture clauses have proved troublesome in Arrangement cases. A Ninth Circuit case involved a lease giving the lessor an option to terminate if "a receiver or other officer or agent be appointed to take charge of the demised premises or the business conducted therein." During the term the lessee sought relief under Chapter XI and an order was entered continuing the debtor in possession. The lessor then sought to terminate the lease. The court held that the lessee was not operating the business as a free lessee, but that its function was analogous to that of a receiver in equity, and that accordingly the lessor was entitled to terminate. The opinion viewed the debtor as an agent of the court, but did not hold that debtor was a receiver. A dissenting judge took the position that the lessee's possession had not been disturbed.⁶¹

In a late district court case in another circuit an opposite conclusion was reached. There a lease clause authorized termination in the event of an

55. *Finn v. Meighan*, 325 U.S. 300, 89 L.Ed. 1624, 65 Sup. Ct. 1147 (1945).

56. *Model Dairy Co. v. Foltis-Fischer*, 67 F. 2d 704 (2d Cir. 1933).

57. *In re Wil-Low Cafeterias*, 95 F. 2d 306 (2d Cir. 1938), *cert. den.* 304 U.S. 567 (1938); *In re Wise Shoe Co. Inc.*, 26 F. Supp. 762 (S.D. N.Y. 1938); *In re Walker*, 93 F. 2d Cir. 281 (1937).

58. *In re Technical Marine Maintenance Co.*, 169 F. 2d 548 (3rd Cir. 1948).

59. *Smith v. Hoboken R.W. & S.C. Co.*, 328 U.S. 123 (1946).

60. *In re Clerc Chemical Corp.*, 142 F. 2d 672 (3d Cir. 1944); *In re Murray Realty Co.*, 35 F. Supp. 417 (N.D. N.Y. 1940).

61. *Urban Properties Corp. v. Benson*, 116 F. 2d 321 (9th Cir. 1940).

assignment by operation of law, an adjudication in bankruptcy, or the appointment of receiver. It was decided that under this wording the granting of an order continuing the debtor in possession did not fall within the purview of the forfeiture clause, that the lessor was not authorized to terminate.⁶²

Even where a lease terminates *ipso facto* upon bankruptcy, a lessor may waive his right to terminate. In a Seventh Circuit case it was held that a lessor, by billing monthly "for the use of the premises during the month" and by acceptance of payments as rent knowing that bankruptcy proceedings had been instituted, thereby waived the breach.⁶³ But where such payments are made for use and occupation, it is generally held that in the absence of clear and convincing proof that the lessor intended to waive the breach, he should not be considered as having done so.⁶⁴

III. CALCULATION OF AMOUNT OF LANDLORD'S CLAIM

The determination of the amount of the landlord's claim for damages due to the anticipatory breach of the lease covenants is not always a simple matter. Normally the landlord would liquidate his claim by discounting future payments of the rent reserved by the lease, without acceleration even though the lease contained an acceleration clause, and by deducting therefrom the rental value of the remainder of the term discounted to its present worth.⁶⁵ In the case of ordinary bankruptcies, the amount thus arrived at may not exceed the amount of rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises to the landlord or the date of the re-entry by the landlord, whichever first occurs. In Corporate Reorganization and Arrangement cases, the period is three years instead of one. In a case that starts out as a reorganization proceeding but is superseded by ordinary bankruptcy, the one-year limitation applies.⁶⁶

The formula for determining the landlord's damages has been held to be mandatory. That is to say, the courts ordinarily will not apply on

62. *In re* Burke, 76 F. Supp. 5 (S.D. Cal. 1948).

63. *In re* Sound, 171 F. 2d 253 (7th Cir. 1948), *cert. den.* 336 U.S. 962 (1949).

64. *In re* Wil-Low Cafeterias, 95 F. 2d 306 (2d Cir. 1938), *cert. den.* 304 U.S. 567 (1938); *In re* Schulte Retail Stores Corp., 22 F. Supp. 612 (S.D. N.Y. 1937); *In re* Walker, 93 F. 2d 281 (2d Cir. 1937).

65. *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 81 L.Ed. 324, 57 Sup. Ct. 292 (1937); *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 81 L.Ed. 340, 57 Sup. Ct. 298 (1937).

66. *In re* Bonwit, Lennon & Co., 36 F. Supp. 97 (D. Md. 1940).

account of special circumstances a different rule of damages to a claim other than that fixed by the Bankruptcy Act.⁶⁷ In a corporate reorganization case it was held that the landlord's claim for damages would be calculated as of the date of breach and would be based upon the three-year period in spite of the fact that proof of subsequent events showed the landlord himself had been dispossessed approximately a year after bankruptcy.⁶⁸ It has been held in a number of cases that under Section 63a(9)⁶⁹ a landlord has an absolute right, but is limited, to damages accruing through the rejection of a lease, the claim being also limited to the amount of a year's rental.⁷⁰ In computing the amount of the claim, the term "rent" includes the return, whether of money, service or specific property, which the tenant makes to the landlord as compensation for the use of the demised premises.⁷¹ If upon the liquidation of a claim in a reorganization proceeding the deduction of the present rental value from the present value of rent reserved in the lease leaves a difference which exceeds the amount of total rent for the three years succeeding the landlord's re-entry, the claim may be allowed only for such amount of total rent for the three years. The surplus is not provable as against the interest of stockholders, not otherwise reserved in any way. And such limitation is constitutional.⁷² The period has been held to begin to run from the time the trustee rejected the lease, rather than from the subsequent date when the landlord obtained actual possession of the property.⁷³

In a reorganization proceeding where the debtor was the guarantor of the covenants of a bankrupt lessee, it was held that the statutory limit to the amount of three years' rent would be applied, although the situation was one not within the letter of the statute. Otherwise, the court stated, the liability of the guarantor would be greater than that of the principal.⁷⁴ The same result was reached in a case involving a surety.⁷⁵

Since a claimant has the burden of proving his claim, a lessor has the

67. *In re* Jas. Butler Grocery Co., 22 F. Supp. 995 (E.D. N.Y. 1938).

68. *In re* Huyler's of Delaware, Inc., 30 F. Supp. 298 (S.D. N.Y. 1939).

69. 11 U.S.C. § 103a(9) (1946).

70. *Wheeling Valley Coal Co. v. Mead*, 186 F. 2d 219 (4th Cir. 1950); *Rocky Mountain Fuel Co. v. Whiteside*, 110 F. 2d 778 (10th Cir. 1940); *In re Benguiat*, 20 F. Supp. 504 (S.D. Cal. 1937).

71. *In re* Bonwit, Lennon & Co., 36 F. Supp. 97 (D. Md. 1940).

72. *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 81 L.Ed. 340, 57 Sup. Ct. 298 (1937).

73. *In re* United Cigar Stores Co., 86 F. 2d 629 (2d Cir. 1936), *cert. den.* 300 U.S. 679 (1936).

74. *Hippodrome Bldg. Co. v. Irving Trust Co.*, 91 F. 2d 753 (2d Cir. 1937), *cert den.* 302 U.S. 748 (1937).

75. *In re* Schulte Retail Stores Corp., 105 F. 2d 286 (2d Cir. 1939).

burden of proving the difference between the amount of rent reserved and the market value thereof at the time of bankruptcy. In the absence of proof it will be assumed that the two are the same.⁷⁶

Two cases, both involving the application of deposits made for security, deserve special mention because of the manner in which the court calculated damages and provided for the proving of the claim. In the first, a Second Circuit case, the Tonto Realty Company was the lessor of certain premises in New York City under a lease with the bankrupt expiring January 31, 1948. The lease contained an *ipso facto* clause, and a covenant providing that in the event of bankruptcy there should be due the lessor as liquidated damages a sum to be computed as therein provided, representing the difference between the cash value of the rent reserved and the cash rental value for the balance of the term. The lessee deposited \$3000.00 as security for the faithful performance of his obligations under the lease. During the term the lessee was adjudicated a bankrupt, and the lessor filed its claim for damages for the breach of the lease. The referee in bankruptcy computed the lessor's liquidated damages to be approximately \$40,500.00, deducted the amount of the \$3000.00 deposit, resulting in a net of \$37,300.00. He then found that the maximum amount for which the claim could be allowed under Section 63a(9) was approximately \$26,000.00, arriving at this figure by adding to the amount of one year's rent the amount of accrued unpaid rent. The claim was allowed for \$26,000.00. The District Court⁷⁷ held that the amount of the \$3000.00 deposit should be deducted, not from the gross amount of damages, but from the \$26,000.00 calculated under Section 65a(9). For the Circuit Court of Appeals Judge Clark, in a decision that constitutes an elaborate and painstaking review of the history of landlords' claims in bankruptcy, concluded that in the light of the history and purpose of the 1934 amendment and of its clearly expressed intent, it should be construed so that the total claim of a landlord with security should not exceed the statutory limit and that the amount of the security should be deducted therefrom; that otherwise the landlord would be given a claim for the statutory maximum plus the amount of his security. There was a vigorous dissent by Judge Frank, who argued that it was not intended by this section to deprive a landlord of the benefit of his bargain, that the amount of the deposit should be applied to the unsecured balance just as it is applied in the case of a claim of a wholly

76. *Kessler v. Jefferson Storage Corp.*, 125 F. 2d 108 (6th Cir. 1941).

77. *In re B. Westermann Co.*, 51 F. Supp. 776 (S.D. N.Y. 1943).

unsecured landlord, and that the claim ought to be allowed for the maximum permissible under Section 63a(9).⁷⁸

A recent Tenth Circuit case is exceedingly troublesome. It involved a lease dated March 30, 1946, with a term of approximately ten years. The minimum annual rental reserved was \$15,000.00, payable in monthly installments of \$1,250.00. Certain covenants of the instrument provided for the return of the leased premises to the lessor upon termination in as good condition as when leased, and it was further stipulated that the filing of a petition in bankruptcy should be deemed to constitute a breach of the lease "and thereupon *ipso facto* and without entry or other action by the lessor this lease shall become and be forfeited; and, notwithstanding any other provisions of this lease, the lessor shall forthwith upon such forfeiture, be entitled to recover damages for such breach." The sum of \$7,500.00 was deposited "to guarantee the performance" of the lease.

On August 9, 1949, a petition in bankruptcy was filed against the lessee. On August 30, the lessee was adjudicated. One Porter, first as receiver and later as trustee, took possession and remained in possession of the premises until February 1, 1950, at which time he surrendered possession to the lessor; and during the time of his occupancy Porter paid the agreed minimum rental. Thereafter the lessor filed its claim for damages for a breach of the rental contract in the sum of \$18,000.00, less the sum of \$7,500.00 held as security.

On a hearing before the Referee three witnesses qualified as experts testified that the \$1,250.00 reserved rental was a fair rental value of the property, but one of them stated this was true if a tenant could be found, another stated that there was no way of telling how long the property would be vacant, while the third stated that rental values are generally fixed by the market price of adjoining property. There was no other proof of fair rental value, but the lessor was permitted to show that the property remained vacant from February 1, 1950, the date of surrender by the Trustee, until October 1, 1950, despite all efforts to rent, and that on October 1, 1950, a portion of the premises were rented for \$833.33 per month. The lessor introduced a calculation of its rental loss, showing a total of \$16,091.99.

The Referee and District Judge under the general rule that the lessor's damage is measured by the difference between the present value of re-

78. *Oldden v. Tonto Realty Co.*, 143 F. 2d 916 (2d Cir. 1944).
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served rent and the present fair rental value of the remainder, "the two of which are presumed to be the same," held that the two were the same, that there was *no* loss, and that the Trustee was entitled to the \$7,500.00 deposit.

The Tenth Circuit Court of Appeals reversed the case outright.⁷⁹ The court evidently found that the lessor suffered damages as claimed by it, but the same were limited to \$15,000.00, the reserved rent for one year. The lessor apparently was held entitled to retain the \$7,500.00 deposit, and to a general claim for the balance of \$7,500.00. The court held that the judgment below, based, according to the opinion, on the hypothesis that the present rental value was equal to the reserved rent, could not stand; and accepted as proof the evidence of loss submitted by the lessor. The court referred to, but failed to apply, the doctrine that the amount of the lessor's claim should be calculated by deducting the rental value of the remainder of the term from the rental reserved, both discounted to present worth. It seems the court was satisfied that the lessor proved a loss exceeding the maximum amount for which the claim could be proved, and accordingly allowed the claim for such maximum.

The difficulty with such reasoning is that it entirely overlooks consideration of the rental value of the premises for the entire remaining term of the lease. It might well be that the trustee could have submitted relevant proof thereof. That the burden was upon the lessor to prove his damages was conceded; but the lessor's proof in the trial court consisted of proof of damage for a particular period of time, and did not include proof of the rental value of the lease. The decision seems contrary to the weight of authority.⁸⁰

Ordinarily provability of rent past due at the time of bankruptcy presents no particular problem. If the landlord's claim is only for rent past due and unpaid, it is of course readily provable under the provisions of Section 63a(1), covering fixed liabilities, or under 63a(4), covering open accounts and contracts. But where in addition to past due rent the landlord has a claim for future rent, and desires to prove the same in addition to the claim for past due rent, then the landlord must proceed under Section 63a(9). The latter section contains a clause relating to past due rent in

79. *Stimson Co. v. Porter* 195 F. 2d 410 (10th Cir. 1952).

80. *In re Huyler's of Delaware, Inc.*, 30 F. Supp. 298 (S.D. N.Y. 1939); *In re Jas. Butler Grocery Co.*, 22 F. Supp. 995 (E.D. N.Y. 1938); 3 COLLIER, BANKRUPTCY 1909 (14th ed. 1941).

that it provides that in addition to the amount of the claim for anticipatory breach, the landlord is entitled to an amount equal to the unpaid rent accrued up to the date of the surrender of the premises or the date of re-entry, whichever occurs first, whether before or after bankruptcy. When the landlord is thus proceeding, he is accordingly bound as to past due rent by the limitations of Section 63a(9). In the event that surrender or re-entry occurred, as it sometimes does, prior to the filing of the petition, past due rent in such event can be proved only to such date.⁸¹

An eminent authority makes the observation that under the wording of Section 63a(9), a landlord's claim may include rent accruing after the petition in bankruptcy is filed if the surrender or re-entry does not occur until some subsequent date.⁸² It would appear, however, that ordinarily the landlord would claim and be entitled to payment as an expense of administration, *i.e.*, as compensation for use and occupation, for the period of time after filing of the petition up to the time of surrender or re-entry.

IV. DISPOSITION OF SECURITY DEPOSITS

Any discussion of the decisions involving the disposition of deposits made to secure the performance by lessees of their agreements to pay rent and to perform the other covenants of their leases is exceedingly difficult because of the various differences in state law, in lease covenants, and in the particular situations involved.

Where a deposit is made merely as security for the performance of the covenants of a lease, with no provision that it be forfeited as liquidated damages, and bankruptcy intervenes and the lease is then completely terminated, the trustee in bankruptcy is entitled to the deposit upon the payment of all accrued rent.⁸³ Where the covenants of the lease provide that the landlord may retain a deposit as security for the valid covenants providing for the payment of damages caused by the loss of rentals sub-

81. *Rocky Mountain Fuel Co. v. Whiteside*, 110 F. 2d 778 (10th Cir. 1940); 3 *COLLIER, BANKRUPTCY* 1895-1896 (14th ed. 1941).

82. 3 *COLLIER, BANKRUPTCY* 119 (14th ed., 1951 Supp.), citing *Wheeling Valley Coal Corp. v. Mead*, 186 F. 2d 219 (4th Cir. 1950).

83. *Floro Realty & Inv. Co. v. Steem Electric Corp.*, 128 F. 2d 338 (8th Cir. 1942); *Jensen v. Sparkes*, 53 F. 2d 433 (9th Cir. 1931); *Cannon v. Fifty-Sixth Street Garage, Inc.*, 45 F. 2d 110 (2d Cir. 1930); *Belstrat Hotel Corp. v. Somoff*, 37 F. 2d 16 (2d Cir. 1930); *In re Frey*, 26 F. 2d 472 (D.C. Pa. 1928); *In re Barnett*, 12 F. 2d 73 (2d Cir. 1926), *cert den.* 273 U.S. 699 (1926); *Seattle Rialto Theatre Co. v. Heritage*, 4 F. 2d 668 (9th Cir. 1925).

For the effect of a security deposit on calculation of the lessor's allowable claim, see *Odden v. Tonto Realty Co.*, 3479, note 78 and supporting text.

sequent to the termination of the lease, the tenant's obligations survive the termination of the lease, and the landlord may retain the security until the expiration of the term.⁸⁴ But where a lessor conspires to prevent the lessee from performing the terms of the lease, the lessor cannot retain the deposit for application to the rent for the last months of the term even though the lease contained a so-called "survival clause."⁸⁵

There are certain situations where no right for the return of a deposit exists. If the deposit is clearly consideration for the execution of the lease, the lessor may retain it,⁸⁶ but in such a case it should appear that title to the deposit passed to the landlord.⁸⁷ Then again, where a deposit was made not as security for the fulfillment of covenants, but in fact as an advance payment for rent to accrue in the future for a specified period, it has been held that title to the deposit passed to the lessor and became his property.⁸⁸

Where the deposit is clearly and properly designated as liquidated damages, to be retained by the lessor upon termination of the lease during its term on account of the lessee's breach of covenant, the lessors are entitled to retain the deposit as against the lessee's bankruptcy trustee.⁸⁹ A stipulation in a lease providing that a deposit be regarded as liquidated damages and not as a penalty, and be retained by the lessor in the event of a breach of covenants by the lessee, is of course not conclusive.⁹⁰

Another earlier New York case is of some interest because it presents the reverse of the ordinary situation. There the lessor became bankrupt. The lessee had deposited \$5,000.00 to be held by the lessor under a provision for faithful performance of covenants, and in the event of performance, to be applied to the payment of rent for the last six months of the term. The lessor agreed to pay interest on the deposit (which according to many cases indicates that the lessee retained title to the deposit). After adjudication the lessee objected to continuing to pay rent, but paid under protest, and after a foreclosure by the holder of a mortgage petitioned for a refund from the trustee out of the proceeds of rentals on hand an amount equal

84. *In re Luria*, 46 F. Supp. 305 (E.D. N.Y. 1942); *Model Dairy Co. v. Foltis-Fischer*, 67 F. 2d 704 (2d Cir. 1933); *In re Homann*, 45 F. 2d 481 (2d Cir. 1930).

85. *In re Kantor's Delicatessen*, 34 F. Supp. 898 (E.D. N.Y. 1940).

86. *In re Sun Drug Co.*, 4 F. 2d 845 (9th Cir. 1925).

87. *In re Owl Drug Co.*, 12 F. Supp. 431 (D. Nev. 1935).

88. *Slone Properties v. Colvin*, 190 F. 2d 401 (4th Cir. 1951).

89. *Burns Trading Co. v. Welborn*, 81 F. 2d 691 (10th Cir. 1936), *cert. den.* 298 U.S. 672 (1936); *In re Sherwoods*, 210 Fed. 754 (2d Cir. 1913).

90. *In re Sherwoods*, 210 Fed. 754 (2d Cir. 1913).

to the payments made by him under protest. The petition was denied, on the ground that the lessee had only a general credit.⁹¹

Perhaps the most important conclusion to be drawn from the cases, both by the student and by the active practitioner, is that the rights of parties to a lease may be seriously affected by the use or misuse of a few words or by the inclusion or omission of an essential paragraph. It is highly unlikely that a careful draftsman of an ordinary contract will include or omit verbiage essential to his client's rights, whereas the average lawyer frequently fails to realize the implications of inclusions or omissions in lease contracts which in the event of bankruptcy will seriously affect the rights of his client. In no other situation may the unthinking use of a printed form be as unwise as in the case of rental agreements.

91. *In re Banner*, 149 Fed. 936 (S.D. N.Y. 1907).