

# The Wasted Sacrifice of Lessors' Lost Profit Claims in Bankruptcy

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# The Wasted Sacrifice of Lessors' Lost Profit Claims in Bankruptcy

Marie T. Reilly\*

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## I. INTRODUCTION

Bankruptcy Code section 502(b)(6) sets the maximum allowable amount of a real property lessor's claim for damages arising from breach of lease.<sup>1</sup> To the extent that a lessor's damages claim under nonbankruptcy law exceeds the maximum amount, it is disallowed in the tenant's bankruptcy case. The implicit premise for such disallowance is that real property lessors' damages claims are less worthy of respect in bankruptcy than other claims for damages against the debtor.<sup>2</sup> Real property leases are legally distinct from other contractual relationships that allocate property rights.<sup>3</sup> But, it does not obviously follow from the distinction that a

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1. 11 U.S.C. § 502(b)(6) (1994). The section imposes a cap on the allowed amount of that portion of a lessor's bankruptcy claim that "result[s] from the termination of a lease of real property." See *infra* note 14. Section 502(b)(6) is one of several bankruptcy provisions that alter creditors' nonbankruptcy rights against a debtor as part of a bankruptcy case. See, e.g., 11 U.S.C. §§ 544, 547, 548, 550 (1994).

2. See Sen. Rep. No. 95-598, at 63, reprinted in 1978 U.S.C.C.A.N. 5787, 5849 ("[Section 502(b)(6)] is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate."). See *Nostas Assocs. v. Costich* (In re Klein Sleep Products, Inc.), 78 F.3d 18, 28 (2d Cir. 1996) (purpose is to compensate a lessor for the loss suffered but ensure that the lessor's potentially "monstrous" claim does not consume the entire estate.); In re Goldblatt Bros., Inc., 66 B.R. 337, 346 (Bankr. N.D. Ill. 1986) ("[I]t ensures that non-lessor creditors recover more than the minimal portions of their claims they would recover if landlord claims resulting from termination of long term leases were allowed in full . . . [and] ensures that lessors obtain a reasonable portion of the damages they suffered as a result of an abandonment of a lease by a bankrupt.").

3. Under the Bankruptcy Code, the claims of non-debtor parties to unexpired leases are treated under Section 365. 11 U.S.C. § 365 (1994). See generally Charles Tabb, *The Law of Bankruptcy* 575-80 (1997).

damages claim for breach of a real property lease is inferior to other claims. Because it discriminates against real property lessors' lost profit claims, Section 502(b)(6) contravenes the bankruptcy slogan that like-situated creditors ought to be treated alike, or that "equality is equity."<sup>4</sup>

This article considers Section 502(b)(6) in light of the political, economic, and legal forces that shaped it. Part II explains how Section 502(b)(6) applies to a lessors' claim. Part III explores the history of real property lessors' claims for damages in bankruptcy cases from the beginning of the twentieth century. Part IV considers the stated justifications for disallowance of lessor's claims under Section 502(b)(6) and concludes that they are unconvincing. Disallowance of part of lessors' damages claims under Section 502(b)(6) reflects and perpetuates irrational bias against such claims. Moreover, such disallowance contradicts both contractual theory and modern bankruptcy policy.

## II. AN EXPLANATION OF SECTION 502(B)(6)

Bankruptcy Code section 502 governs the extent to which creditors' rights against the debtor will be recognized against the bankruptcy estate. The process of claim recognition or "allowance" has two facets, liquidation and evaluation. Claim allowance refers in part to the process by which a court determines the present value of contingent rights. A creditor's rights against the debtor might be fully mature and liquidated; or they might be contingent on the debtor's default, the passage of time, or the occurrence of some other event. These contingent rights against the debtor, although not yet actionable under nonbankruptcy law, constitute bankruptcy "claims."<sup>5</sup> Once bankruptcy law transmogrifies contingent rights into present claims, it must also provide for the present valuation of such rights.<sup>6</sup> Section 502 provides that, if ordinary resolution of a contingency or liquidation of a claim would "unduly delay the administration of the case," the bankruptcy court must estimate

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4. See, e.g., *Allied Artist Pictures Corp. v. Allied Artist Television Corp.* (In re Allied Artists Indus., Inc.) 35 B.R. 737, 740 (Bankr. S.D.N.Y. 1983) (stating Code purpose of equitable distribution). Professor Thomas Jackson described this principle as "perhaps the most common—and uncontroversial—of bankruptcy's policies." Thomas Jackson, *The Logic and Limits of Bankruptcy Law* 29 (1986). *Simonson v. Granquist*, 369 U.S. 38, 82 S. Ct. 537 (1962); *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 57 S. Ct. 298 (1937); *Canright v. General Fin. Corp.*, 35 F. Supp. 841, 844 (E.D. Ill. 1940).

5. 11 U.S.C. § 101(5)(1994). H.R. Rep. No. 95-595, at 309 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5963, 6266; S. Rep. No. 95-989, at 21-22 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 5807-08. "Claim" means a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." *Id.* See *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991) (CERCLA response costs are bankruptcy claims where release or threatened release occurs prior to the filing of the petition); *Grady v. A. H. Robbins Co.*, 839 F.2d 198 (4th Cir. 1988). *But see In re M. Frenville Co.*, 744 F.2d 332 (3d Cir. 1984), *cert. denied*, 469 U.S. 1160, 105 S. Ct. 911 (1985). See generally *Tabb*, *supra* note 3, at 472 ("As long as the operative events underlying the claim took place prior to bankruptcy, the creditor has a claim for bankruptcy purposes.").

6. 11 U.S.C. § 502(b), (c) (1994); see generally *Tabb*, *supra* note 3, at 487-92.

the amount of such claim for the purpose of allowance.<sup>7</sup> The relevant moment at which to value all rights against the estate is the filing of the bankruptcy petition.<sup>8</sup>

Section 502 has another function apart from claim liquidation. If a party in interest objects to an asserted claim, the bankruptcy court must evaluate the merits of the claim. The court must disallow a claim if it falls in whole or in part into one or more of the categories set forth in Section 502.<sup>9</sup> The effect of claim disallowance is stark. In a liquidation case, a creditor is not entitled to distribution to the extent its claim is disallowed.<sup>10</sup> In a reorganization case, disallowance dilutes the creditor's voting power, and diminishes her ultimate recovery under a plan.<sup>11</sup> In either type of proceeding, if the debtor receives a discharge, the disallowed portion of a creditor's claim is discharged and the creditor's rights are to that extent extinguished forever.<sup>12</sup> Disallowance also redistributes loss among claimants. It redistributes loss equal to the value of the disallowed claim from the class of creditors would otherwise bear it pro rata to the creditor in that class whose claim is disallowed.<sup>13</sup>

Section 502(b)(6), the subject of this article, is one of the grounds for disallowance. It establishes the allowability of a claim "of a lessor for damages resulting from the termination of a lease of real property."<sup>14</sup> The damage claim

7. 11 U.S.C. § 502(c) (1994). See generally Tabb, *supra* note 3, at 486-87. Section 502(c) provides no detail as to how a court "shall estimate" a contingent or unliquidated claim.

8. 11 U.S.C. § 502(b) (1994) ("[T]he court . . . shall determine the amount of such claim as of the date of the filing of the petition.")

9. 11 U.S.C. § 502(b) (1994). Claims are "deemed allowed" if a creditor files a proof of claim unless a party in interest such as the debtor, the trustee, or another creditor, objects. 11 U.S.C. § 502(a)(1994); Bankruptcy Rule 3002(a). If such a party objects, the court must conduct a hearing on the allowability of the claim. 11 U.S.C. § 502(b) (1994). See generally Tabb, *supra* note 3, at 482-87. The delineated grounds for disallowance in Section 502(b) fall into three categories: (1) timing rules (e.g., rights not in the nature of "claims" are not allowed); (2) substantive nonbankruptcy law objections to asserted claims (e.g., estate succeeds to all defenses which would be valid under nonbankruptcy law, § 502(b)(1)); and (3) bankruptcy specific policies (e.g., disallowing claims: for unmatured interest, § 502(b)(2); for tax assessed against property of the estate to the extent the claim exceeds the value of the estate's interest in the property, § 502(b)(3); for services of an insider or an attorney of the debtor in excess of the reasonable value of those services, 502(b)(4); for spousal or dependant support maturing post-petition that are nondischargeable under § 523(a)(5), § 502(b)(5); for damages by a real property lessor for breach of lease, § 502(b)(6); for damages by an employee for breach of contract, § 502(b)(7); for certain employment tax, § 502(b)(8); by a transferee of an avoidable transfer under certain circumstances, § 502(d); for reimbursement or contribution that is contingent or subject to right of subrogation, § 502(e)).

10. 11 U.S.C. § 726 (1994). See also Tabb, *supra* note 3, at 467.

11. The holder of an entirely disallowed claim may not vote on any plan of reorganization. 11 U.S.C. § 1126(a) (1994). The holder of a partially disallowed claim may vote and participate in the plan but only to the extent her claim is allowed. *Id.*, 11 U.S.C. § 1129(2)(B) (1994).

12. E.g., *In re Lindsey*, 199 B.R. 580, 583 (E.D. Va. 1996). Bankruptcy discharge is codified at 11 U.S.C. §§ 524(a)(b), 727, 944, 1141, 1228, 1328 (1994).

13. A real property lessor's claim for damages is treated as an unsecured claim. See 11 U.S.C. § 365(g) (1994).

14. Section 502(b) reads in part:

[T]he court . . . shall allow such claim in . . . such amount, except to the extent that—

(6) such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—

subject to Section 502(b)(6) arises in one of two ways. A real property lessor can experience damages as a consequence of the tenant's material breach of the lease. If the rent the lessor expected under the lease exceeds the market value of the leased premises, the tenant's anticipatory breach of lease will cause the lessor to experience lost profit.

Alternatively, a lessor can experience such damages by the operation of bankruptcy law. Suppose a tenant files for bankruptcy relief while the lease is not terminated.<sup>15</sup> The trustee can either assume or reject the lease for the benefit of the estate.<sup>16</sup> The Bankruptcy Code provides that rejection of the lease is the equivalent of breach under nonbankruptcy law.<sup>17</sup> The lessor under a rejected lease determines his claim for damages as though the lease terminated immediately prior to the filing of the petition.<sup>18</sup> These damages "result[] from the termination of a lease of real property" by operation of Section 365 and Section 502(b)(6) applies to the lessor's claim.<sup>19</sup>

As a threshold matter, Section 502(b)(6) does not affect a lessor's claim for rent which became due but which the tenant did not pay prior to the filing of the bankruptcy petition. The lessor's right to back rent is distinct from his right to damages resulting from termination. Termination of the lease extinguishes a lessor's right to unaccrued rent.<sup>20</sup> But, it has no effect on the lessor's right to rent which

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates[.]

11 U.S.C. § 502(b)(6) (1994).

15. The relevant bankruptcy term for a lease that is not terminated as of the commencement of the case is "unexpired." 11 U.S.C. § 365 (1994).

16. 11 U.S.C. §§ 365(a), 1107(a) (1994); *Orion Pictures Corp. v. Showtime Networks Inc.* (In re Orion Pictures), 4 F.3d 1095, 1098 (2d Cir. 1993), *cert. denied*, 511 U.S. 1026, 114 S. Ct. 1418 (1994).

17. 11 U.S.C. § 365(g) (1994).

18. 11 U.S.C. § 365(g)(i) (1994). In re *McClellan Enters., Inc.*, 105 B.R. 928, 934 (Bankr. W.D. Mo. 1989) (claim against debtor for rejection of lease constitutes damages resulting from termination under 502(b)(6)). See generally *Tabb*, *supra* note 3, at 590. Bankruptcy Code section 365(d)(3) requires a trustee to pay rent due under an unexpired lease for nonresidential real property that accrues post-petition but pre-rejection. 11 U.S.C. § 365(d)(3) (1994). Upon rejection, the lessor is entitled to an administrative expense claim for the post-petition, pre-rejection use value of the premises. If the debtor-in-possession assumes the lease, the lessor is entitled to treatment under Section 365. 11 U.S.C. 365 (1994). If the debtor-in-possession subsequently breaches the assumed lease, the lessor's claim for damages is allowed in full as an administrative expense claim not governed by Section 502(b)(6). *Nostos Assocs. v. Costich* (In re *Klein Sleep Products, Inc.*), 78 F.3d 18 (2d Cir. 1996). See *Thomas Devaney, The Klein Sleep Decision: Section 502(b)(6) Lease Damages Cap as the Rule, Not the Exception*, 4 Am. Bankr. Inst. L. Rev. 557 (1996) (criticizing result in *In re Klein Sleep*).

19. *E.g., McClellan Enters., Inc.*, 105 B.R. at 934.

20. Robert S. Schoshinski, *American Law of Landlord and Tenant* 382, 383 nn.25, 26 (1980); *Restatement (2d) of Property (Landlord and Tenant)* § 14.2 cmt. e (1977).

accrued prior to termination.<sup>21</sup> Thus, a lessor's claim for rent accrued but unpaid prior to termination does not "result from the termination of a lease of real property." Although Section 502(b)(6) would not appear to affect this aspect of a lessor's claim in the first place, Subpart B of Section 502(b)(6) expressly allows in full a lessor's claim for unpaid rent due prior to termination of the lease.<sup>22</sup>

Subpart A of Section 502(b)(6) sets the maximum allowable amount of the lessor's claim for damages caused by termination of the lease. To illustrate how Section 502(b)(6) works, consider the following example. Suppose two parties entered into a twenty five-year lease beginning on January 1, 1984 and ending on December 31, 2008 for office space at a monthly rent of \$1,000. The tenant paid rent through July 31, 1997 but made no further payments. By its terms the lease terminated and the tenant abandoned the property on December 31, 1997. Under the lease, the tenant agreed to pay damages for breach of lease equal to the difference between: 1) the present value of aggregate rent that would have become due but for the breach; and 2) the rental value of the property during the remaining term. Immediately after the tenant abandoned the property, the lessor was able to relet it for \$600 per month (60% of the original rent). On July 1, 1998, six months after termination of the lease, the tenant filed for bankruptcy.

Under the lease, the lessor could assert a claim against the tenant for five months of back rent due but unpaid for August 1 through December 31, 1997. This aspect of the lessor's claim will be allowed in full in bankruptcy. Although, as noted above, a claim for back rent does not "result[] from the termination of a lease of real property," Section 502(b)(6)(B) makes it clear that the lessor's claim for back rent covering the period August through December 1997 (pre-termination) shall be allowed in full.<sup>23</sup>

This lessor also experienced lost profit resulting from the premature termination of the lease on December 31, 1997. If the tenant never filed for bankruptcy, the lessor's claim against the tenant for lost profit would be governed exclusively by the terms of the lease and applicable state law. The lease terminated with eleven years remaining. At five percent interest, eleven years of monthly \$1,000 payments has a present value of \$101,374. To calculate the lessors' lost profit, it is necessary to subtract from this amount the present value of the recovered premises. In this example, the present value of the revenue the lessor obtained upon reletting, again at five percent interest, is \$60,824. The lessor's lost profit on account of the

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21. Schoshinski, *supra* note 20. Claims in bankruptcy for back rent were historically treated distinctly from claims based on the lease. *E.g.*, In re Sherwoods, 210 F. 754 (2d Cir. 1913); In re Chakos, 24 F.2d 482 (7th Cir. 1928).

22. 11 U.S.C. § 502(b)(6)(B) (1994). The amount allowed is "any unpaid rent due under such lease, without acceleration, on the earlier of [the date of the filing of the petition and the date on which such lessor repossessed, or the lessee surrendered, the leased property]." *Id.*

23. See discussion *supra* note 20-21 and accompanying text. See also In re Atlantic Container Corp., 133 B.R. 980, 987 (Bankr. N.D. Ill. 1991) (damages caused to the premises by the tenant's failure to perform repair and maintenance covenants are unrelated to termination of the lease and thus not governed by Section 502(b)(6)).

tenant's breach of the lease is \$40,550.<sup>24</sup> The lessor's total claim as calculated under state law would be \$45,550 (\$5,000 back rent, plus \$40,550 for lost profit).

Now observe the effect of Section 502(b)(6)(A) on the lessor's allowed claim for lost profit in bankruptcy. In this hypothetical, the tenant's default triggered termination of the lease under nonbankruptcy law. The "remaining term of such lease," as that term appears in Section 502(b)(6)(A), commenced on December 31, 1997 upon the abandonment by the tenant and concomitant repossession of the premises by the lessor.<sup>25</sup> It ends upon the natural expiration of the lease, December 31, 2008, eleven years hence. The total "rent reserved by such lease, without acceleration" over the entire eleven year remaining term is \$132,000.

Section 502(b)(6)(A) fixes the maximum allowed claim for lost profit as a portion of this "rent reserved." The applicable portion varies depending on the length of the remaining term. Section 502(b)(6)(A) states that a lessor's maximum allowed claim for lost profit shall equal rent reserved "for the greater of one year, or 15 percent not to exceed three years, of the remaining term of such lease."<sup>26</sup> Unlike the typical contractual or implied measure of damages which *nets* the present value of foregone revenue and recovered market value, the formula in Section 502(b)(6)(A) fixes the maximum allowable claim for lost rent revenue (measured in some cases by percentage of rent, in others by the rent due over a set period of time), without regard to the actual or hypothetical market value of the premises.

Section 502(b)(6)(A) sets the maximum allowed lost profit claim as the portion of rent reserved that would accrue over fifteen percent of the remaining term of the lease, subject to two adjustments. First, a lessor is always entitled to a claim equal to twelve month's worth of rent, even if fifteen percent of the reserved rent over the remaining term is less. Second, a lessor's allowed claim for lost profit can never exceed three year's worth of rent, even if fifteen percent of rent reserved is greater.<sup>27</sup>

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24. \$101,374 (present value of lost revenue) minus \$60,824 (present value of premises) equals \$40,550.

25. The alternate triggering events described in Section 502(b)(6)(A)(i) and (ii) describe mutually exclusive occurrences whereupon a lessor obtains or is deemed to obtain the exclusive right to possess and exploit the subject premises. 11 U.S.C. § 502(b)(6)(A)(i), (ii) (1994).

26. The language of Section 502(b)(6)(A) is daunting. See Lisa Sommers Gretchko, *Coping With Rejection § 502(b)(6)—The Evolving Law of Lease Rejection Damages*, 15 Am. Bankr. Inst. J. 36 (1996) (Section 502(b)(6) is "poorly worded and hard to understand."). In the same sentence, it defines the maximum allowed amount of a lessor's lost profit claim by reference to the aggregate amount of "rent reserved by such lease" over a specific period of time, and a specific percentage of such rent reserved. In re Iron-Oak Supply Corp., 169 B.R. 414, 415-16 (Bankr. E.D. Cal. 1994). The cap is stated alternatively in terms of years of rent (at least 1 but no more than 3 year's worth) or percentage of rent reserved by the lease (15 percent). See In re Allegheny Int'l, Inc., 145 B.R. 823, 828 (Bankr. W.D. Pa. 1992) ("Congress intended the phrase 'remaining term' to be a measure of time not rent.").

27. For leases with remaining terms of less than 6.5 years, the maximum allowed claim for lost profit declines from 100% of reserved rent (for leases with a one year remaining term) toward 15% of reserved rent as the remaining term increases. For leases with remaining terms greater than 6.5 years but less than 20 years, the maximum allowed claim remains constant at 15% of reserved rent. For leases with remaining terms greater than 20 years, the maximum allowed claim declines from 15% toward 0% as the remaining term increases.

Returning to the hypothetical, the lessor's maximum allowed claim for lost profit under Section 502(b)(6)(A) is fifteen percent of \$132,000, or \$19,800.<sup>28</sup> The lessor can add his claim for back rent, in this case, \$5,000, to his maximum lost profit claim for a total allowable bankruptcy claim of \$24,800. The effect of Section 502(b)(6)(A) in this hypothetical is to disallow \$20,750 of the lost profit component of the lessor's claim (\$40,550-\$19,800). The balance of the class of unsecured creditors are correspondingly enriched by this amount.

### III. THE HISTORY OF SECTION 502(B)(6)

#### A. *Anticipatory Repudiation and Lessors' Claims for Lost Profit*

Consider a real property lessor's rights against a tenant under nonbankruptcy law.<sup>29</sup> The scope of a lessor's remedies against a defaulting tenant depend on the terms of the lease, and the statutory and common law of the relevant jurisdiction. If a tenant breaches the lease, typically a lessor can: 1) terminate the lease relationship and rescind the conveyance of the leasehold;<sup>30</sup> and 2) enforce whatever contractual rights he may have against the tenant for damages for anticipatory breach of lease.<sup>31</sup>

The first remedy is essentially recourse against the leased premises itself, analogous to a secured lender's right to foreclose upon the pledged collateral.<sup>32</sup> The second remedy compensates the lessor for his lost expectation of profit, if any. The two remedies are cumulative, but the lessor may not recover more than his loss on account of the breach. Thus, a lessor's damages for breach of lease take into account the value of the lessor's recourse to the property. When real property values are stable or rising, a lessor who has a right to recover the property will probably not experience lost profit on account of the tenant's breach. Indeed, in a rising market the lessor will actually be better off by the tenant's breach. Recovering the property allows the lessor to relet it at a rent greater than the rent under the breached lease. When the rent for the breached lease exceeds the expected market value of the leased property over the remaining term, however, the lessor will experience lost

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28. One year's worth of reserved rent is \$12,000 so 15% of the rent reserved is greater.

29. Section 502(b)(6) takes as its starting point, a real property lessor's rights against the tenant under state law. See, e.g., *Kohn v. Leavitt-Berner Tanning Corp.*, 157 B.R. 523 (N.D. N.Y. 1993); *In re Lindsey*, 199 B.R. 580 (E.D. Va. 1996).

30. The lessor's right to reenter upon the tenant's default can arise from a provision in the lease. *Schoshinski*, *supra* note 20, at 377-78. Most states have enacted statutes that establish the lessor's right to terminate the lease and reenter even in the absence of an express term in the lease. *Id.* at 377, 394. See also Restatement (2d) of Property, Landlord and Tenant § 12.1 (1977). The Uniform Residential Landlord and Tenant Act limits the lessor's right to terminate to cases of material breach by the tenant. *Unif. Residential Landlord and Tenant Act* § 4.201, 4.207, 78 U.L.A. 493, 498 (1972). See *Schoshinski*, *supra* note 20, at 4 n.10 and *Supp.* 1998 at 19 for list of states adopting the uniform law.

31. See generally *Schoshinski*, *supra* note 20, at 375-85.

32. The analogy between the lessor's right to reenter and a mortgagee's right to foreclose was recognized in scholarly commentary on real property lessors' rights as early as 1933. See *Wolfgang S. Schwabacher & Sidney C. Weinstein*, *Rent Claims in Bankruptcy*, 33 *Colum. L. Rev.* 213, 243 (1933).



profit. Leases typically measure the lessor's damages as the positive difference, if any, between the present value of rent that would have become due but for the breach, and the present value of the premises over the remaining term of the lease.<sup>33</sup>

From the foregoing non-controversial exposition, it is not clear why real property lessors' claims for damages have been singled out for disparate treatment in their tenant's bankruptcy cases throughout the last century.<sup>34</sup> What feature of real property lessors' claims for lost expectation distinguish them from lost expectation claims of other creditors? The history of the interpretation of real property lease relationships in the United States sheds some light on this question.

"Lease" connotes a relationship in which the lessor conveys to the tenant a possessory estate, while the lessor holds a longer estate in the same property.<sup>35</sup> The conveyance almost always occurs within the context of a contract regarding the respective rights and obligations of the parties throughout the term of the lease.<sup>36</sup> In contrast, under the common law of real property, the lessor unconditionally grants a leasehold estate to the tenant. And by "reservation of rent" the tenant

33. For an example of a stipulated damages provision drafted to maximize the lessor's allowable claim in the tenant's bankruptcy see James M. Hoffman & Douglas K. Hirsch, *Don't Underestimate Bankruptcy Clauses In Commercial Leases*, 9 No. 11 Com. Leasing L. & Strategy S-3 (April 1997). Courts imply such a measure of damages when the lease does not supply an express stipulation. *E.g.*, *Kearns v. Gay*, 232 F. Supp. 475, 479 (M.D. N.C. 1964); *Piggly Wiggly Southern, Inc. v. Eastgate Assoc. Ltd.*, 392 S.E.2d 337, 339 (Ga. Ct. App. 1990); *Bastian v. Albertson's Inc.*, 643 P.2d 1079, 1084 (Idaho 1982); *Washington Trust Bank v. Circle K Corp.*, 546 P.2d 1249, 1252 (Wash. Ct. App. 1976).

34. See *Collier on Bankruptcy*, at ¶ 502.LH[3][a] (Lawrence P. King ed., 15th ed. 1998) ("from a strictly logical point of view there should be no need or justification to treat leases differently from other bilateral contracts. . ."); Max Radin, *Claims for Unaccrued Rent in Bankruptcy*, 21 Cal. L. Rev. 561, 562 (1933) ("Whatever minute and subtle discriminations courts find between [a tenant's] rent-obligations and his other debts, it is not apparent that the rent obligor—the tenant—feels any difference.").

35. See generally Schoshinski, *supra* note 20, at 1 ("A lease is conventionally defined as a transfer of the right of possession of specific property for a temporal period or at will."); Roger A. Cunningham et al., *The Law of Property* 256 (1984); 1 *American Law of Property* 177 (James A. Casner ed., 1952). During the term of a leasehold, the land in question is subject to two estates: the tenant's present possessory estate and the landlord's future estate upon reversion of the property to him at the termination of the lease. *Id.* Before the sixteenth century, a tenant obtained no estate in land by virtue of the lease. Rather, his rights were purely contractual. Leases of land during this period were probably used primarily as devices to evade usury laws. See generally 1 *American Law of Property* 175, 202 (1952); Theodore F.T. Plucknett, *A Concise History of the Common Law* 367-68 (1st ed. 1928); Sir Frederick Pollock, Frederic W. Maitland, *History of English Law* 116-113 (2d ed. 1923).

36. Schoshinski, *supra* note 20, at 2-6. "[I]t has been observed that a modern lease ordinarily involves multiple and mutual running covenants between lessor and lessee, that the transaction is essentially a bilateral contract involving a continuing exchange of promises and performances rather than a completed conveyance of an estate in land or property." *Id.* at 4; 1 *American Law of Property* § 3.11 (1952). For an exposition of the ponderous evolution of the relationship between real property landlord (lessor) and tenant see, Hiram H. Lesar, *The Landlord-Tenant Relation in Perspective: From Status to Contract and Back in 900 Years?*, 9 U. Kan. L. Rev. 369, 377 (1961); John F. Hicks, *The Contractual Nature of Real Property Leases*, 24 *Baylor L. Rev.* 443 (1972); Hiram H. Lesar, *Landlord and Tenant Reform*, 35 *N.Y.U. L. Rev.* 1279 (1960); Restatement (2d) *Property (Landlord and Tenant)* 1-6 (1977). See also Radin, *supra* note 34, at 563 ("[T]he relation of landlord and tenant is one of the most perverse, complicated and irrational of all common law situations. . .").

acknowledges fealty to the landlord.<sup>37</sup> The estate is not conditional on the rent nor vice versa because demise of a leasehold is perfectly valid even if it includes no reservation of rent.<sup>38</sup> The independence of the demise from the compensation given for it is the antithesis of a contractual relationship.<sup>39</sup>

The presumption that the lessor and tenants' obligations are independent dictates the remedies available to an aggrieved party upon the nonperformance of the other. Absent a specific agreement to the contrary, the tenant's estate in the land does not depend on his payment of rent. Thus, a lessor's only remedy at common law for the tenant's nonpayment of rent is a series of actions for specific performance—to compel the tenant to pay rent as it becomes due.<sup>40</sup>

Of course, parties have by contract escaped the common law presumption of independent obligations.<sup>41</sup> By the beginning of the twentieth century, leases routinely made the tenant's performance of his obligations a condition of his right to possess the premises. And courts enforced the contractual dependence of lease covenants.<sup>42</sup>

For reasons that remain obscure, American courts in the beginning of the twentieth century did not embrace a completely contractual conception of leasehold relationships. Courts treated express terms reserving to the lessor the right to reenter upon the tenant's default in rent as a forfeiture of the tenant's estate. For that

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37. John Emmerson Bennett, *The Law of Landlord and Tenant* 216 (1939). See Radin, *supra* note 34, at 563. See generally P.S. Atiyah, *The Rise and Fall of Freedom of Contract* 317 (1979) (discussing theory of rent in 19th century England).

38. Herbert Tiffany, 1 *Landlord and Tenant* § 165 (1910). Tiffany noted: "The cases, however, of a demise without any reservation of rent are but few, and the rights and liabilities of the parties in reference to rent constitute an important part of the law of landlord and tenant." *Id.*

39. *E.g.*, 1 *American Law of Property* 202-203 (1952); see generally Atiyah, *supra* note 37, at 208-09. The persistence of the unilateral conveyance paradigm in the interpretation of leasehold relationships may reflect the fact that law governing estates in real property developed before that of dependent contractual covenants. 3 Samuel Williston, *A Treatise on the Law of Contracts* § 890 (Samuel Williston, George J. Thompson rev. ed. 1936). Bennett, *supra* note 37, at 132-35. One commentator disputes that at common law lease obligations were ever independent. William M. McGovern, Jr., *Dependent Promises in the History of Leases and Other Contracts*, 52 *Tul. L. Rev.* 659, 679 (1978) ("Rarely has a proposition about legal history been so often asserted with so little evidence to support it.").

40. *E.g.*, *Oliver v. Loydon*, 124 P. 731 (Cal. 1912); *Michaels v. Fishel*, 62 N.E. 425, 427 (N.Y. 1902); *Sutter v. Goodman*, 80 N.E. 608 (Mass. 1907).

41. See 1 *American Law of Property* 205 (1952) ("[A] large part of the job of drafting leases, particularly where the bargaining power of the parties is fairly equal, is to draft provisions avoiding anachronistic rules based on the idea that a lease is for all purposes and only a conveyance."). Notwithstanding the absence of express language in a lease, courts have abandoned the common law independence of leasehold covenants in favor of a contractual interpretation. For example, courts have implied into a leasehold relationship a lessor's warranty that the premises shall be habitable. The tenant's obligation to pay rent is impliedly conditional on the lessor's performance of this warranty. *Schoshinski*, *supra* note 20, at 122-24.

42. See *Schoshinski*, *supra* note 20, at 377-78. See, e.g., *Hiatt Inv. Co. v. Buehler*, 16 S.W.2d 219 (Mo. 1929); *Higgins v. Whiting*, 131 A.2d 879 (N.J. Sup. Ct. 1926). See also McGovern, *supra* note 39, at 677 and 705 (observing that covenant dependence was common in leases under the common law).

reason, courts strictly construed the right to reenter against the lessor.<sup>43</sup> Moreover, absent language in the lease to the contrary, courts interpreted the lessor's right to reenter and terminate the lease as his exclusive remedy against the tenant.<sup>44</sup>

A lessor's right to recover money from his tenant (distinct from his right to reenter the leased premises) was coextensive with his right to specific enforcement of the tenant's obligation to pay rent. A lessor had such right only while the leasehold estate remained intact. To get rent, the lessor had to forego his right to reenter the premises and terminate the lease. To get the premises, the lessor had to forego his right to rent, and with it any hope of recovering lost profit.<sup>45</sup>

A tenant who defaulted on his rent obligation and abandoned the premises posed a dilemma for the lessor. The lessor could tolerate the default and abandonment and sue the tenant periodically for rent notwithstanding that the tenant was no longer in possession of the premises. Because the lease was not technically terminated, the tenant meanwhile had the right to possess the premises, and the lessor had the corresponding right to rent as it became due. Although the leased premises lay idle, that was the tenant's affair and of no consequence to the lessor's right to periodic rent. Alternatively, the lessor could terminate the lease and reenter the premises, but forego his right to revenue (rent) in excess of the current expected market value of the leased premises (lost profit).

The lessor proceeded at his peril. Courts treated the tenant's abandonment as an implicit offer to surrender (and terminate) the lease.<sup>46</sup> Any post-surrender act by the lessor of dominion over the property following the tenant's default and abandonment could constitute acceptance of the tenant's offer of surrender by operation of law.<sup>47</sup> The lease would thereupon terminate by operation of law, and the lessor forfeit any further right to rent.<sup>48</sup>

In some jurisdictions, as long as the lessor did not reenter the premises, the lessor could sue the abandoning tenant for the full rent as it became due under the lease without reduction for the market value of the idle property.<sup>49</sup> Other

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43. *E.g.*, Exchange Sec. Co. v. Rossinin, 186 P. 828 (Cal. Dist. Ct. App. 1919) (under Cal. Civ. Code). *See generally* Bennett, *supra* note 37, at 131.

44. *E.g.*, 1 American Law of Property § 3.9 (1952). Some courts still take this view. *See* Schoshinski, *supra* note 20, at 378 and nn.5 and 9 and Supp. 1998, at 222; 1 American Law of Real Property § 5.06[2][a] (1994).

45. For the common law rule that a lessor has no action or claim for rent following eviction and reentry in the absence of the survival of an independent covenant, see *e.g.*, International Publications, Inc. v. Matchabelli, 184 N.E. 51 (N.Y. 1933); Cornwell v. Sandford, 118 N.E. 620 (N.Y. 1918); South Side Trust Co. v. Watson, 200 F. 50 (3d Cir. 1912).

46. *See generally*, Glen Weissenberger, *The Landlord's Duty to Mitigate on the Tenant's Abandonment: A Survey of Old Law and New Trends*, 53 Temple L. Rev. 1 (1980).

47. The lessor had no right to rent after the lessor accepts the tenant's offer of surrender. *E.g.*, Minneapolis Co-op v. Williamson, 52 N.W. 986 (Minn. 1892); Gray v. Kaufman Dairy & Ice Cream Co., 56 N.E. 903 (N.Y. 1900); Merrill I. Schnellby, *Operative Facts in Surrenders*, 22 Ill. L. Rev. 22, 117 (1927); Charles T. McCormick, *The Rights of the Landlord Upon Abandonment of the Premises by the Tenant*, 23 Mich. L. Rev. 211 (1925); Clarence M. Updegraff, *The Element of Intent in Surrender by Operation of Law*, 38 Harv. L. Rev. 64 (1924).

48. Restatement (2d) of Property (Landlord and Tenant) § 12.1(3) and cmt. i, at 393 (1977).

49. *E.g.*, Merrill v. Willis, 70 N.W. 914 (Neb. 1897); Heighes v. Porterfield, 214 P. 323 (N.M.

jurisdictions permitted a lessor to relet the premises upon the tenant's abandonment without terminating the lease, provided the lessor gave notice to the abandoning tenant of the reletting.<sup>50</sup> If the lessor did so, the lessor could sue the tenant for rent reduced by the revenue obtained on reletting. The operative fiction in these jurisdictions was that the lessor relet "on the tenant's account," preserving the essential idea that the lessor continuously respected the tenant's superior right of possession.<sup>51</sup>

It is no surprise that parties to leases bargained around the confines of this restrictive interpretation. Even in jurisdictions that did not permit the lessor to both reenter and sue for rent deficiency, (that is, obtain lost expectation), parties to leases created such a result by bargain. By covenant, the tenant agreed that, upon default, the lessor could reenter the premises *plus* recover from the tenant the difference between rent to become due and the market value of the premises over the unexpired term of the lease.<sup>52</sup>

Real property lawyers cloaked their contractual innovation with old rhetoric. Tenants expressly covenanted to pay an amount, frequently denominated as "rent," as damages for breach of lease.<sup>53</sup> The covenant, known as an "indemnity covenant," expressly survived termination of the leasehold.<sup>54</sup>

By the end of the first quarter of the twentieth century, the development of a contractually-based right to damages notwithstanding termination of the lease exposed an issue that had been lurking in earlier decisions denying such right. Traditionally, if a lessor chose to ignore a tenant's default and preserve his right to rent, he could not accelerate the rent to become due and sue for it all at once because no rent became due before its time.<sup>55</sup> If a lessor's right to damages was to be based on a contractual covenant (rather than on the independent, common law right to rent), should the lessor be entitled to anticipatory relief in damages, or be relegated to the periodic, specific performance of the rent covenant?

1923); *Goldman v. Broyles*, 141 S.W. 283 (Tex. Civ. App. 1911). *But see* *Benson v. Iowa Bake Rite Co.*, 221 N.W. 464 (Iowa 1928) (duty to mitigate).

50. *E.g.*, *Baskin v. Thomas*, 12 F.2d 845 (D.C. Cir. 1926); *Von Schleinitz v. Norm Hotel Co.*, 23 S.W.2d 64 (Mo. 1929); *Kottler v. New York Bargain House, Inc.*, 150 N.E. 591 (N.Y. 1926); Note, *Surrender by Operation of Law*, 81 U. Pa. L. Rev. 848 (1933).

51. Note, *supra* note 50, at 851-52.

52. Max Radin, *Claims for Unaccrued Rent in Bankruptcy II*, 22 Cal. L. Rev. 1, 20 n.42, 21 (1933) ("[m]ost leases do permit reentry and reletting and thus imply that the landlord has a remedy that sounds in damages."). *See, e.g.*, *Hermitage v. Levine*, 162 N.E. 97, 98 (N.Y. 1928); *Kottler v. New York Bargain House*, 150 N.E. 591 (N.Y. 1926); *Mann v. Munch Brewery*, 121 N.E. 746 (N.Y. 1919). California courts implied a right to re-enter and recover damages in apparent derogation of the common law rule precluding recovery of both the premises and damages. *See* *Oliver v. Loydon*, 124 P. 731 (Cal. 1912); *Philips-Hollman, Inc. v. Peerless Stages Inc.*, 291 P. 178 (Cal. 1930).

53. *E.g.*, *Kottler v. New York Bargain House*, 150 N.E. 591 (N.Y. 1926).

54. *See, e.g.*, *United Cigar Store of America v. Friend*, 257 Ill. App. 359 (1930); *Farley v. Craig*, 11 N.J.L. 262 (1830); *Van Rensselaer v. Ball*, 19 N.Y. 100 (1859); *Kottler v. New York Bargain House*, 150 N.E. 591 (N.Y. 1926); *Hermitage Co. v. Levine*, 162 N.E. 97 (N.Y. 1928). An indemnity covenant expressly conditional on the tenant's default was described as "rare" in a 1933 article. *See* William O. Douglas & Jerome Frank, *Landlords' Claims in Reorganizations*, 42 Yale L.J. 1003, 1006 (1933).

55. Tiffany, *supra* note 38, at § 166; Bennett, *supra* note 37, § 148.

At about the same time that the indemnity covenant surfaced in lease litigation, the doctrine of anticipatory repudiation had emerged in contract law.<sup>56</sup> Upon one party's complete and unequivocal refusal to perform executory obligations (anticipatory repudiation), the other party could *both* suspend his own performance, and enforce immediately his damage remedy for breach.<sup>57</sup> Damages for anticipatory breach were measured as of the time of the breach notwithstanding temporal or other conditions on the breacher's obligation to perform.<sup>58</sup> The remedy for damages took into account the present value of the cost saved by the non-breacher in not having to perform over time.<sup>59</sup>

Anticipatory relief was thought to be unavailable to a party who had fully rendered his performance.<sup>60</sup> Such a party was relegated to wait until the bargained for performance would otherwise have been rendered but for the breach. To permit such a party an immediate right to damages would give him more than he bargained for.<sup>61</sup> The fundamental schism between a lessor's lost profit claim as a corollary of

56. *E.g.*, *Roehm v. Horst*, 178 U.S. 1, 20 S. Ct. 780 (1900) (recognizing doctrine of anticipatory repudiation as federal common law); *Central Trust Co. of Illinois v. Chicago Auditorium Ass'n*, 240 U.S. 581, 589, 36 S. Ct. 412, 414 (1916) (declaration of bankruptcy constitutes anticipatory repudiation of executory contracts) discussed at *infra* note 120 and accompanying text. *See also* Restatement, Contracts § 318 (1932); 5 Williston, Contracts §§ 1296-1337 (rev. ed. 1937) [hereinafter 5 Williston on Contracts]. In the first quarter of the twentieth century, the scope of the doctrine of anticipatory repudiation was the subject of scholarly disagreement. Samuel Williston, *Repudiation of Contracts*, 14 Harv. L. Rev. 317, 421 (1901); Henry W. Ballentine, *Anticipatory Breach and the Enforcement of Contractual Duties*, 22 Mich. L. Rev. 329 (1924); Herbert R. Limburg, *Anticipatory Repudiation of Contracts*, 10 Cornell L.Q. 135 (1925). Williston disagreed with the doctrine. 5 Williston on Contracts, *supra*, § 1321 (asserting that the doctrine enlarged the obligation of contract beyond the bargain made by the parties).

57. *E.g.*, *Roehm v. Horst*, 178 U.S. 1, 20 S. Ct. 780 (1900); 5 Williston on Contracts, *supra* note 56, § 1314 n.1 and cases cited therein.

58. 5 Williston on Contracts, *supra* note 56, § 1317; Restatement (2d) Contracts § 348(3) (1977).

59. 5 Williston on Contracts, *supra* note 56, § 1350.

60. *See, e.g.*, *Roehm v. Horst*, 178 U.S. 1, 17, 20 S. Ct. 780, 786 (1900) (the obligations of the party to pay under "an ordinary money contract, such as a promissory note, a bond . . . [where] the consideration has passed . . ." does not fall within the doctrine of anticipatory repudiation). 5 Williston on Contracts, *supra* note 56, § 1328 ("[N]o unilateral promise for an executed agreed exchange to pay money at a future day can be enforced until that day arrives."); Restatement, Contracts § 318 (1932). *But see* Comment, *Anticipatory Breach of Unilateral Contracts*, 36 Yale L.J. 263 (1926) (questioning exclusion of unilateral contracts from anticipatory relief).

61. Williston responded to critics who argued that anticipatory relief ought to be available to an aggrieved party who had fully performed: "[W]hen the only requirement of the contract is the promisor's future performance it more obviously is unjust to hold him liable to action immediately, than where performances are to be rendered by both parties. In the latter case, waiting until the agreed time has its effect on the whole agreed exchange; in the former case, allowing the promisee immediate recovery is nothing but a direct bonus to the promisee beyond what he was promised and a direct penalty to the promisor." 5 Williston on Contracts, *supra* note 56, § 1328, at 3734-3735. This view persists. *See* Restatement (2d) Contracts § 243(3) (1977) ("Where at the time of the breach the only remaining duties of performance are those of the party in breach and are for the payment of money in installments not related to one another, his breach by non-performance as to less than the whole, whether or not accompanied or followed by a repudiation, does not give rise to a claim for damages for total breach."); *but see* 4 Arthur L. Corbin, Contracts § 962 (1951) (the reasons for the doctrine of anticipatory repudiation "are equally applicable to unilateral contracts."); John D. Calmari & Joseph

his right to rent on the one hand, and a contractual right to damages on the other, fueled uncertainty and conflict regarding the application of the doctrine of anticipatory repudiation to such claim.<sup>62</sup> If the lessor's claim for damage derived exclusively from his right to rent, then, absent an express damages covenant, the lessor had no right to accelerate all rent installments upon the default of a single payment.<sup>63</sup> If the lease contained such a damages covenant, the lessor ought, in theory, have the same rights as a lender under a defaulted loan with an acceleration clause.

The emergence of a distinctly contractual right to damages for breach of lease broke down the theoretical barrier to anticipatory relief for lessors. But many courts remained steadfast in refusal to recognize a true anticipatory remedy for lost expectation. At the beginning of the twentieth century, New York courts treated lessors' rent based claims differently than damages claims. On neither claim did the lessor win a true anticipatory remedy. Lessors who sought to accelerate their right to rent under a technically non-terminated lease were met squarely with the common law tradition that rent is not "due" before the corresponding period of possession expired. Alternatively, if the lessor sought damages for breach of lease under an indemnity covenant, the court would enforce the covenant only if the lease expressly provided that the covenant survived termination. And then, the courts would interpret the lessor's contractual rights against the tenant as narrowly as the language of the lease would permit.<sup>64</sup>

For example, in *Hermitage Co. v. Levine*,<sup>65</sup> the tenant leased a commercial building in New York City for 21 years.<sup>66</sup> After the tenant stopped paying rent, the lessor terminated the lease and evicted the tenant. The lease contained an indemnity covenant that preserved the lessor's right to damages following termination.<sup>67</sup> The

M. Perillo, *The Law of Contracts* § 12.9 (4th ed. 1998).

62. For example, John Bennett in his treatise on the law of leases published in 1939 wrote that the landlord could not sue immediately for damages when the tenant repudiates a lease, but recognized holdings to the contrary. Bennett, *supra* note 37, at § 148 and cases cited therein in nn.73 and 74. Bennett explained the unavailability of anticipatory relief in damages for lessors not on theoretical grounds but rather as a consequence of difficulty of liquidation. "Ordinarily there is available no reliable basis from which to ascertain or compute the nature and extent of the injury which the lessor in such cases will suffer upon a breach. It is this circumstance which commonly renders relief by way of anticipation unavailing. . . ." *Id.*

63. See, e.g., *Jordon v. Nickell*, 253 S.W.2d 237 (Ky. 1952); *Cooper v. Casco Mercantile Trust Co.*, 186 A. 885 (Me. 1936); *Maflo Holding Corp. v. S.J. Blume Inc.*, 127 N.E.2d 558, 561 (N.Y. 1955); *McCready v. Lindenborn*, 408, 65 N.E. 208, 210 (N.Y. 1902).

64. E.g., *Jacob Ruppert Realty Corp. v. Bank of United States*, 156 Misc. 93, 281 N.Y.S. 761 (1935); *Hermitage v. Levine*, 162 N.E. 97 (N.Y. 1928).

65. 162 N.E. 97 (N.Y. 1928).

66. *Id.* at 97.

67. The lease contained the following language:

In case the tenant shall be dispossessed or ejected, or shall remove from or abandon the demised premises after a demand for the rent or the service of a notice as provided by section 1410 of the Civil Practice Act, or after the commencement of dispossess proceedings, or for any other reason, the landlord may re-enter the said premises by force or process of law or otherwise, and relet the same as agent for the tenant, and the tenant shall remain

lessor relet various floors of the building to substitute tenants for varying terms.<sup>68</sup> A little over a year after the eviction, the lessor brought an action against the original tenant for the deficiency between the original lease rent and the rent on reletting that had accrued up to that time.<sup>69</sup> The tenant contended that the lessor's complaint was premature.

Rather than arguing directly for extension of the doctrine of anticipatory repudiation to his claim for damages, the lessor asked merely that his claim for damage be construed as though it were a rent-based claim—so as to afford him a right to sue for deficiency periodically during the original term.<sup>70</sup> Judge Cardozo ruled against the lessor on the ground that the clause did not expressly permit periodic recovery of damages.<sup>71</sup> The indemnity clause was silent as to *when* the lessor could recover damages, and thus did not afford the lessor a cause of action prior to the end of the original term, some twenty years away.<sup>72</sup>

liable for all damages which the landlord may sustain by any such breach of this agreement, or through such entry or reletting.

*Id.* at 97.

68. *Id.*

69. *Id.*

70. *Id.* at 98. In a case decided two years earlier, Judge Cardozo drew a hard distinction between the lessor's claim for damages arising from termination of the lease, and for rent made while the lease was still in effect. In *Kottler v. New York Bargain House, Inc.*, 150 N.E. 591 (N.Y. 1926), the lessor based its claim on a term which permitted the lessor to reenter and relet the premises as "agent" for the tenant if the tenant should abandon them during the term. In the case of such reentry and reletting, the tenant would be liable for any deficiency and entitled to any surplus between the original and substitute rent. *Id.* at 592. When the lessor sued for the deficiency that had accrued up to the time of suit, the tenant objected on grounds that the lessor's suit was actually a claim for damages (not rent) and was premature until the expiration of the original term about one year later. *Id.* (citing the same authority that later doomed the lessor in *Hermitage*). The court held for the lessor. Because the lease had not terminated upon reentry and reletting, the lessor's claim was for accrued rent, not damages, and thus was not premature. *Id.*

71. *Hermitage*, 162 N.E. at 98 (citing *McCready v. Lindenborn*, 65 N.E. 208, 208 (N.Y. 1902)) (lease therein obligated tenant to pay the difference in rent in equal monthly payments "as the amount of such difference shall from time to time be ascertained."); *Mann v. Munch Brewery*, 121 N.E. 746 (N.Y. 1919) (after termination, tenant was to "continue liable for the payment of the rent and the performance of all of the other conditions herein contained.").

72. *Hermitage*, 162 N.E. at 99. To the same end see, *Phillips-Hollman, Inc. v. Peerless Stages, Inc.*, 291 P. 178, 180 (Cal. 1930) ("law is well settled that the landlord cannot recover [damages] in installments, but must bring his action at the expiration of the original term, at which time the damages for the first time can be ascertained," citing *Hermitage Co. v. Levine*, 162 N.E. 97 (N.Y. 1928)); *Grayson v. Mixon*, 5 S.W.2d 312, 314 (Ark. 1928) (*dicta*).

Correspondingly, under New York law, the lessor was entitled to hold the security deposit for the account of the defaulting tenant until the expiration of the original term of the lease. If it appeared that the lessor's damages would be less than the security deposit, the tenant had no cognizable action to recover the difference until the expiration of the lease term. *Halpern v. Manhattan Ave. Theater Corp.*, 160 N.Y.S. 616, 621 (N.Y. App. Div. 1916) (plaintiff [defaulting tenant] not entitled to recover security deposit "until the expiration of the period of the lease, unless every contingency under which the defendant might have a claim for damages against said fund has been exhausted.").

During this period, anticipatory relief for breach of lease was available to lessors in other jurisdictions.<sup>73</sup> For example, in *Wilson v. National Refining Co.*,<sup>74</sup> the tenant abandoned the property and the lessor relet it. The lessor sued the tenant five months before the expiration of the term for damages equal to the difference between the original and substitute rent to the end of the original lease term. The tenant argued that if the lessor's action was for rent, he was limited to rent due and owing prior to the time of suit. Alternatively, if the claim was for damages, it was premature until the expiration of the original lease term. In *Wilson*, the court found the lessor's damage action was not premature. "Such an action can be commenced immediately upon the breach and abandonment, and covers the damages to the end of the term covered by the lease."<sup>75</sup> In *Wilson*, the expiration of the lease was five months away, compared to twenty years in *Hermitage*.

Given the economic instability of the last part of the nineteenth century, and the onset of depression in 1929, arguments for the extension of anticipatory relief to lessors for lost profit under long term leases could not have come at a worse time. Even in those jurisdictions that recognized anticipatory relief, lessors faced a daunting burden of proof with regard to the liquidation of such damages. *Leo v. Pearce Stores Co.*<sup>76</sup> illustrates judicial discomfort with the level of speculation required to fix an anticipatory remedy for breach of a long term lease. During the year before trial in 1931, real property values in Saginaw, Michigan had dropped 25-30%.<sup>77</sup> The real estate broker testifying for the lessor declined to speculate as to the fair rental value of the property during the remaining 18 year term of the lease.<sup>78</sup> The court concluded that although the lessor had failed to meet its burden of proving the fair rental value of the property over the remaining term, the lessor was entitled to \$7,500 "as representing an amount which will fairly compensate him for all of his damages reasonably to be anticipated. . . ."<sup>79</sup>

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73. *E.g.*, *Grayson v. Mixon*, 5 S.W.2d 312 (Ark. 1928); *Curran v. Smith-Zollinger Co.*, 157 A. 432 (Del. 1931); *Wilson v. National Ref. Co.*, 266 P. 941 (Kan. 1928); *Leo v. Pearce Stores Co.*, 57 F.2d 340 (E.D. Mich. 1932); *Novak v. Fontaine Furniture Co.*, 146 A. 525 (N.H. 1929); *Womble v. Leigh*, 142 S.E. 17 (N.C. 1928); *In re Reading Iron Works*, 24 A. 617 (Pa. 1892). The measure of damages for anticipatory breach of lease was governed by the leases in question, which typically set such damages as the difference between the rent reserved and the fair rental value of the premises for the balance of the term. *E.g.*, *Grayson*, 5 S.W.2d 312, *Wilson*, 266 P. 941; *Scott Realty Co. v. United Amusement Co.*, 162 N.W. 283 (Mich. 1917).

74. 266 P. 941 (Kan. 1928).

75. *Id.* at 942. *See also* *Womble v. Leigh*, 142 S.E. 17, 18 (N.C. 1928); *Leo v. Pearce Stores Co.*, 57 F.2d 340, 341 (E.D. MI 1932) ("It is well settled that the proper measure of damages presently recoverable . . . is the present value of the difference between the fair rental value, at the time of such breach, of the leased premises for the balance of the unexpired term and the total agreed rent for such unexpired term."); *Minneapolis Baseball Co. v. City Bank*, 76 N.W. 1024, 1026 (Minn. 1898); *Brown v Hayes*, 159 P. 89 (Wash. 1916); *Novak v. Fontaine Furniture Co.*, 146 A. 525 (N.H. 1929); *Weir v. Cooper*, 84 So. 184 (Miss. 1920) (anticipatory relief available to lessor against sharecropping tenant).

76. 57 F.2d 340 (E.D. Mich. 1932).

77. *Id.* at 341.

78. *Id.* The court took judicial notice of prevailing "abnormally low" real property values. *Id.*

79. *Id.* at 342. The lessor's rights arose in the context of an equitable receivership of the tenant, and the court explained its award as an appropriate exercise of its equitable powers. *Id.*



### B. Lessors' Claims in Bankruptcy Cases

From the turn of the twentieth century to the end of the 1930's, real property lessors' claims for lost profit posed a particularly thorny problem in bankruptcy cases. Intermittent periods of sharp deflation and the depression of the 1930's sent individuals and businesses reeling as fixed costs like rent outpaced deflated revenue.<sup>80</sup> Those facing financial collapse sought relief under the Bankruptcy Act of 1898. Individual debtors wanted to wipe away debt in the bankruptcy proceeding and start fresh.<sup>81</sup> Creditors wanted to maximize their recovery and deflect the loss in value caused by general deflation.

Under the Bankruptcy Act of 1898, when a tenant sought relief in bankruptcy, the threshold question for the lessor was whether his lost profit claim would be "provable" in the tenant's case.<sup>82</sup> If the lessor's rights constituted a provable claim, the lessor could share in the estate as an unsecured creditor.<sup>83</sup> If his rights were not "provable" and the trustee did not assume the lease for the benefit of the estate, the lessor would receive no distribution, but his rights would survive the bankruptcy proceeding. The debtor's bankruptcy discharge would not bar enforcement of his rights.<sup>84</sup> A lessor's nonprovable claim would similarly survive a corporate bankruptcy. However, the post-bankruptcy corporate tenant was likely to be an empty shell, unable to respond to damages meaningfully.<sup>85</sup>

Prior to amendment in 1934, Section 63a of the Bankruptcy Act of 1898 set forth five classes of provable claims.<sup>86</sup> Provability of the lessor's claim was to be

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80. See Douglas & Frank, *supra* note 54, at 1003 (the authors observed that for some chain stores, rent soared to 25% of gross revenue); Schwabacher & Weinstein, *supra* note 32, at 213 (deflation from 1930-33 included collapse of incomes and rental values. "Leases made in boom days, whether for residence or business, have become major economic burdens.").

81. *E.g.*, *Womble v. Leigh*, 142 S.E. 17, 17-18 (N.C. 1928) (tenant abandoned property and told lessor's lawyer "he was going to lock the door and walk out; that [the lessor] could do what she pleased; that she couldn't get anything out of her contract, as he was going into bankruptcy.").

82. The modern analog for "provability" is whether a creditor has a bankruptcy "claim" against the debtor as that term is defined under Section 101(5). 11 U.S.C. § 101(5) (1994). See also *supra* notes 5 and 6 and accompanying text. For a comparative discussion of law governing provability of claims in equity receiverships, see Douglas & Frank, *supra* note 54, at 1006-07.

83. *Zavelo v. Reeves*, 227 U.S. 625, 33 S. Ct. 365 (1913).

84. Section 17 of the Bankruptcy Act of 1898 provided for the discharge of only those claims that were "provable." 42 Stat. 354 (1922).

85. See *In re Portage Rubber Co.*, 296 F. 289, 292 (6th Cir.), *cert. denied*, 266 U.S. 604, 45 S. Ct. 91 (1924) (judicial notice that few creditors with nonprovable claims ever collect anything after bankruptcy).

86. "Debts of the bankrupt may be proved and allowed against his estate which are (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not . . . ; (2) due as costs taxable against an involuntary bankrupt who was at the time of the filing of the petition against him plaintiff in a cause of action which would pass to the trustee and which the trustee declines to prosecute after notice; (3) founded upon a claim for taxable costs incurred in good faith by a creditor before the filing of the petition in an action to recover a provable debt; (4) founded upon an open account, or upon a contract express or implied; and (5) founded upon provable debts reduced to judgments after the filing of the

determined as of the time of the filing of the petition.<sup>87</sup> As a rule of thumb, a claim was provable if it was noncontingent and liquidated or could readily be liquidated as of the time of the filing of the petition.<sup>88</sup>

The rule of thumb was subject to an important qualification. The list of provable claims clearly included some claims that were contingent as of the time of filing. The Bankruptcy Act of 1898 before its amendment in 1934 expressly included among provable debts "a fixed liability, as evidenced by a judgment or instrument in writing, absolutely owing at the time of the filing . . . whether then payable or not. . . ."<sup>89</sup> The statute made a distinction between a debt that was "absolutely owing" although not yet due and other contingent claims. The former, although strictly speaking contingent on the passage of time or preconditions to maturity, were entirely provable. Other contingent claims which were not so "absolutely owing" were not provable. For example, under Section 63a(1), a creditor's rights on an unmatured promissory note, although contingent on the passage of time as of the time of filing, nonetheless constituted a provable claim.<sup>90</sup>

Lessors' claims for unaccrued rent were not provable because the lessor's right to rent, it was said, was contingent on more than the passage of time. It depended on the continuous furnishing by the lessor of the superior right of possession to the tenant.<sup>91</sup> Of course, this reasoning contradicted the common law presumption of independence of leasehold covenants.<sup>92</sup> If the tenant's rent obligation was independent from the lessor's obligations, it would follow that rent would be unconditionally due throughout the term of the lease. Thus, under Section 63a(1), a lessor's claim would be indistinguishable from a holder's claim against a maker of a promissory note—"absolutely owing" except for the passage of time at the time of the filing of the tenant's bankruptcy petition—and thus provable.

Characterizing the lease relationship as an exchange of dependent covenants—contingent and thus nonprovable—raised another problem. If a lessor's claim for lost profit was non-provable because it was contingent on his future performance, then no reason existed to exclude the lessor from anticipatory relief when the tenant repudiated the lease.<sup>93</sup> Recognition of contingency by virtue of the dependence of obligation separated lease relationships from their common law origins and planted them squarely within the realm of contract law.

petition and before consideration of the bankrupt's application for discharge, less costs incurred and interest accrued after the filing of the petition up to the time of the entry of such judgments." Bankruptcy Act, § 63(a) (1933). For the effect of the 1934 and subsequent amendments to the Bankruptcy Act see *infra* notes 188-196 and accompanying text.

87. *E.g.*, *United States v. Marxen*, 307 U.S. 200, 207, 59 S. Ct. 811, 815 (1939); *White v. Stump*, 266 U.S. 310, 313, 45 S. Ct. 103, 104 (1924) (the "line of cleavage" is fixed upon the filing of the bankruptcy petition).

88. Howard L. Oleck, *Creditors' Rights and Remedies* 140-41 (1949). Prof. Oleck warned that liquidatability of a claim was a "crude" heuristic "not to be considered conclusive." *Id.* at 141.

89. Bankruptcy Act of 1898, § 63a(1).

90. *E.g.*, *Williams v. United States Fidelity & Guar. Co.*, 236 U.S. 549, 35 S. Ct. 289 (1915).

91. *See, e.g.*, *In re Roth & Appel*, 181 F. 667, 669 (2d Cir. 1910).

92. *See Radin, supra* note 52, at 13-14; *Schwabacher & Weinstein, supra* note 32, at 217.

93. *See discussion supra* notes 64-72 and accompanying text.

In bankruptcy adjudication, however, logic gave way to expedience. Under pre-amended Section 63a,<sup>94</sup> a lessor could argue his claims were provable under either of two grounds, set forth in subparts (1) and (4).<sup>95</sup> Either a lessor's rights against the tenant/debtor were sufficiently noncontingent under subpart 1 as to constitute "a fixed liability . . . absolutely owing at the time of the filing . . . whether then payable or not," or they were provable under Subpart 4 as "founded upon . . . a contract express or implied."<sup>96</sup>

Suppose a tenant defaulted under the lease and subsequently filed for bankruptcy relief. If the lessor had not terminated the lease prior to the filing of the petition, the lessor's claim against the estate was necessarily a right to rent. Even if a lease contained an indemnity clause, such right to damages was not noncontingent as of the filing because the tenant had not yet breached the lease. As discussed above, a lessor's claim for rent was deemed sufficiently contingent to be not "absolutely owing" under Section 63a, subpart 1. Moreover, because such claims were for rent under a lease, they were not "founded upon a contract." Thus they were not provable under Section 63a(4).

If the lease terminated prior to bankruptcy or if the lease defined the tenant's bankruptcy as automatic termination of the lease, and included an indemnity covenant affording the lessor with an immediate action for damages upon termination, the lessor's claim would be for damages, not for rent. Because the adjudication of bankruptcy constituted an event of termination under the lease, as such adjudication, the lessor would have a noncontingent right to damages. The doctrine of anticipatory repudiation would arguably apply to render such a claim "absolutely owing" as of the time of the filing of the bankruptcy case.<sup>97</sup> Alternatively, such a claim would appear to be provable under Section 63a(4), as "founded upon a contract." But, not so.

The watershed case was *In re Roth & Appel*.<sup>98</sup> The lease at issue defined the tenant's bankruptcy as an event of default triggering the lessor's right to reenter.<sup>99</sup>

94. In 1934, Congress amended Bankruptcy Act of 1898, section 63a to render lessors' lost profit claims provable in part. See *infra* notes 192-196 and accompanying text. The 1934 amendment to Section 63a resolved the controversy regarding the effect of claim contingency on provability. Subpart 7 added to Section 63a read: "Provable debts shall include: . . . (7) claims for damages respecting executory contracts including future rents . . . [but, subject to cap on lessors' claim]." Bankruptcy Act of 1898, § 63a, 11 U.S.C. § 103a, 30 Stat. 562 (1909).

95. See *supra* note 86.

96. *Id.*

97. Absent a lease clause making bankruptcy adjudication an event of termination, tenants on the verge of bankruptcy had an incentive to ensure that their lease was not in default to prevent a provable claim in favor of the lessor. William O. Douglas and Jerome Frank described common debtor/tenant strategy in advance of bankruptcy. "With meticulous care the lawyers for the tenant saw to it that the rent was paid in advance just prior to the filing of the petition in bankruptcy. Accordingly, . . . at the time of the filing . . . there was no provable claim." Douglas & Frank, *supra* note 54, at 1003-04. The Supreme Court in 1916 held that bankruptcy constituted anticipatory repudiation of contract, effectively closing this loophole. See *infra* notes 120-123 and accompanying text.

98. 181 F. 667 (2d Cir. 1910). See Douglas & Frank, *supra* note 54, at 1004 n.3 (describing *Roth* as the "leading case" requiring non-contingency for claim provability).

99. 181 F. at 668. Under modern bankruptcy law, a term that terminates an otherwise unexpired

Upon such default, the lease obligated the tenant to pay an amount equal to rent reserved under the lease, less the amount the lessor might obtain by reletting.<sup>100</sup> The lessor asserted a bankruptcy claim in an amount equal to rent that would have become due, less revenue from the substitute lease from the time the substitute lessee took possession of the premises until February 1909 (although the lease term expired in 1913).<sup>101</sup>

The Second Circuit held that to the extent the lessor's claim was for rent less revenue from reletting, it was not provable. The court reaffirmed the traditional view that a real property lessor had no right to accelerate the rent reserved under the lease upon the tenant's nonpayment of rent.<sup>102</sup> The tenant's obligation to pay rent following bankruptcy was contingent on the tenant's continued superior right to possess the premises.<sup>103</sup> Thus, as of the filing of the bankruptcy petition, the lessor had no claim for rent "absolutely due and owing" and thus, no provable claim under Section 63a(1).<sup>104</sup>

The Second Circuit recognized that the lease in question was "unusual" in that it contained an indemnity clause that expressly reserved for the lessor the option to reenter and terminate the lease upon the tenant's bankruptcy and also sue for damages.<sup>105</sup> Thus, the lessor's claim was not for rent, per se.<sup>106</sup> Rather, the Second Circuit characterized the lessor's claim as "founded upon an agreement to indemnify a landlord for loss of rents following bankruptcy."<sup>107</sup>

The court expressly considered the provability of the lessor's claim for damages under Section 63a(4) as one "founded upon . . . a contract."<sup>108</sup> It held that the parties

lease "ipso facto" upon the tenant's bankruptcy is not enforceable against the trustee or debtor in possession who may assume the lease notwithstanding such clause. 11 U.S.C. § 365 (1994). Moreover, rejection of an unexpired lease constitutes breach by anticipatory repudiation of such lease regardless of the absence of such clause in the lease. *Id.*

100. 181 F. at 668.

101. The significance of February 1909 is unclear from the opinion. The term of the original lease was not set to expire until February 1913. *Id.* at 668.

102. *Id.* at 669.

103. *Id.*

104. *Id.*

105. *Id.* at 671. Presumably this term was included to obtain the benefit of anticipatory relief upon the adjudication of bankruptcy of the tenant. The lessor could argue that his bankruptcy claim was for damages and was fully accrued and non-contingent as of termination which occurred simultaneously upon the filing of the petition. The Second Circuit noted a split of authority on the question of whether the tenant's bankruptcy constituted a termination (or anticipatory repudiation) of the lease absent an express lease clause to that effect. *Id.* at 670. Compare *In re Jefferson*, 93 F. 948 (D. Ky. 1899); *In re Hayes*, 117 F. 879 (W.D. Ky. 1902) (bankruptcy terminates lease) with *Watson v. Merrill*, 136 F. 359 (8th Cir. 1905).

106. It appears that the referee and district court below treated the lessor's claim exclusively as one for rent to become due following the filing of the petition. 181 F. at 670.

107. *Id.* at 671.

108. "The question . . . is . . . whether a claim founded upon an agreement to indemnify a landlord for loss of rents following bankruptcy is provable." *Id.* The Second Circuit's willingness to consider a post-termination damages provision in a lease as creating contractual liability departed from the earlier view of the Eighth Circuit in *Watson v. Merrill*, 136 F. 359 (8th Cir. 1905). In that case, the lessor asserted a claim for damages for breach of the lease in its tenant's bankruptcy case. *Id.* at 360.

to a lease could agree that bankruptcy shall terminate the lease and accelerate all future installments of rent.<sup>109</sup> "Not improbably," the court held, "claims based upon such leases are provable in bankruptcy."<sup>110</sup> The court then distinguished the lessor's claim from those possibly provable claims. The covenant deemed the lease terminated upon the lessor's *reentry*, which the lessor was entitled to do upon the tenant's adjudication of bankruptcy. The court found it significant that the clause did not *require* the lessor to terminate the lease upon the tenant's bankruptcy, but merely gave the lessor the option to do so. "[T]he lessor was not obliged to re-enter, and [as of the adjudication of bankruptcy] whether he would do so or not was manifestly dependent upon uncertainties."<sup>111</sup> Thus, the lessor's claim for damages was, by the terms of the lease, expressly contingent on the lessor's post-petition act to terminate the lease. The court imported the requirement of "absolutely owing" from Section 63a(1) into Section 63a(4).<sup>112</sup> Because the lessor had not re-entered as of the bankruptcy filing, his claim was not "absolutely owing" at that time. Thus, it was not provable as "founded upon a contract" under Section 63a(4).<sup>113</sup>

The court in *In re Roth & Appel* did not interpret the lease covenant in question under the law of any particular jurisdiction. Neither its opinion nor opinions below reveal whether or which state's law applied to govern whether the lessor's claim under the particular lease was sufficiently noncontingent as to be "absolutely owing" at the time of the filing of the petition.<sup>114</sup> After *Hermitage v. Levine*, with which the

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The lessor contended that the tenant's bankruptcy constituted an anticipatory repudiation of all contractual obligations and that his claim was provable under Section 63a(4) as "founded upon . . . a contract." *Id.* The Eighth Circuit had held that regardless of how the lessor characterized the claim, it was for rent to accrue post-petition, and therefore, was not provable. *Id.*

109. 181 F. at 671.

110. *Id.* (citing *In re Pittsburgh Drug Co.*, 164 F. 482 (W.D. Pa. 1908)) (lease provided rent acceleration clause upon tenant's default; on bankruptcy of tenant, the entire rent was "a fixed liability absolutely owing" and provable against the tenant/debtor's estate).

111. 181 F. at 671-72. Apparently, lessors at the time preferred to reserve the option to treat a lease as terminated upon the tenant's default rather than render default an automatic event of termination. *See Radin, supra* note 34, at 561.

112. *See also In re Huchcraft*, 247 F. 187 (E.D. Ky. 1917); *Colman Co. v. Withoft (In re Sweeney)*, 195 F. 250 (9th Cir. 1912); *In re Pettingill & Co.*, 137 F. 143 (D. Mass. 1905); *First Nat'l Bank of Pikeville v. Elliot*, 19 F.2d 427 (6th Cir. 1927). *See Schwabacher & Weinstein, supra* note 32, at 217-21 ("The history of bankruptcy legislation both in England and in the United States pointed to such a result, for never had proof of contingent claims been allowed under statutes which like the [Bankruptcy Act of 1898] made no express provision therefor; and statutes designed to permit proof of such claims had been construed in a ruthlessly narrow and technical fashion."). *But see Moch v. Market St. Nat'l Bank*, 107 F. 897, 897-98 (3d Cir. 1901) (claim against endorser/debtor held provable under Section 63a(4) notwithstanding contingency: "The first and fourth subdivisions of section 63 are distinct provisions, and are, we think, independent of each other.").

113. *In re Roth & Appel*, 181 F. 667, 673 (2d Cir. 1910) (citing *Dunbar v. Dunbar*, 190 U.S. 340, 345, 350, 23 S. Ct. 757, 759, 761 (1903) (claim of divorced wife in estate of former husband under an contract to pay an annuity to her "during her life or until she remarries" held not provable under Section 63a(4) (and thus not dischargeable by the husband) on grounds that the contingency of her remarriage rendered the claim "substantially impossible" to value or estimate)).

114. *See also Watson v. Merrill*, 136 F. 359 (8th Cir. 1905); *In re Bissinger*, 5 F.2d 106 (N.D. Ohio 1925). Other federal courts were careful to apply the common law of the state whose law governed the

Second Circuit was no doubt familiar, a lessor had no immediate right to anticipatory relief upon termination of a lease (and certainly no such right upon the tenant's default prior to termination).<sup>115</sup>

Recall that if a claim was not provable, it was not dischargeable and survived the debtor's bankruptcy case.<sup>116</sup> The *Roth* court's narrow reading of Section 63a(4) to exclude from provability contract claims that were contingent on breach at the time of the filing of the petition correspondingly decreased the range of obligations dischargeable in the debtor's bankruptcy case.

This narrow interpretation of Section 63a(4) adopted by the Second Circuit in *In re Roth & Appel* did not last long. Five years later, in *Williams v. United States Guaranty & Fidelity Co.*,<sup>117</sup> the Supreme Court held that a surety's claim against his indemnitor, although contingent on the default of the indemnitor, could be provable as "founded upon a contract" under Section 63a(4) even though it was not "absolutely due and owing" at the time of the filing of the petition.<sup>118</sup> The decision in *Williams* was based on the peculiar nature of the suretyship relationships at issue and the special statutory provisions that governed them. For this reason, the case did not completely put to rest the question of whether all contingent contract claims were provable under Section 63a(4).<sup>119</sup>

In *Central Trust Company of Illinois v. Chicago Auditorium Association*,<sup>120</sup> the Supreme Court blew open the threshold for provability of bankruptcy claims. The Court held that the filing of a bankruptcy case constituted anticipatory breach of all contracts, eliminated as a matter of law any contingency regarding the debtor's default, and rendered provable creditors' consequent claims for damages.<sup>121</sup> Prior to *Chicago Auditorium*, the federal courts were in conflict on the effect of bankruptcy as anticipatory breach of contract.<sup>122</sup> The Court resolved the question

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lease to determine contingency. As early as the 1920's, the Sixth Circuit proclaimed that it determined the substantive nature of lessors' claims based on state law. *Schneider v. Springmann*, 25 F.2d 255 (6th Cir. 1928); *Wells v. Twenty-First St. Realty Co.*, 12 F.2d 237 (6th Cir. 1926).

115. See *supra* notes 65-72 and accompanying text.

116. See *supra* notes 84-85 and accompanying text.

117. 236 U.S. 549, 35 S. Ct. 289 (1915).

118. In *Williams*, a surety attempted to enforce its claims for indemnification against a partnership. The partnership asserted its prior bankruptcy discharge as a defense. The Court held that the surety's indemnity claim was provable (although not proved) in the prior bankruptcy and thus discharged. Although the debtor had not yet defaulted on its indemnity obligation to the surety at the time the petition in bankruptcy was filed, it had defaulted on the underlying (assured) obligation at that time. The Court held that the claim of a surety for indemnification, contingent on default of the indemnity agreement by the debtor at the time the debtor's bankruptcy petition was filed, was nonetheless provable. The effect of the decision was to render the partnership's defense of discharge valid against the surety, thus expanding the scope of the discharge for the partnership. The Court asserted that holding the surety's claim to have been provable in the prior case, notwithstanding that it was contingent on the debtor's default, was consistent with Congress' intent that bankruptcy serve a rehabilitative purpose.

119. See *Radin*, *supra* note 52, at 8.

120. 240 U.S. 581, 36 S. Ct. 412 (1916).

121. *Id.* at 589, 36 S. Ct. at 414.

122. *Id.* See also *supra* cases cited in note 105.

as a matter of federal bankruptcy law. Bankruptcy constituted an anticipatory repudiation of all executory contracts regardless of the effect of bankruptcy on the aggrieved party's rights under the particular contract or state law.<sup>123</sup>

The claim in question arose under a contract between Scott Transfer Company and the Chicago Auditorium Hotel. The transfer company had agreed to make monthly payments for the exclusive right to provide baggage and livery services to patrons of the hotel. The hotel could terminate the contract upon the transfer company's default without releasing the company from liability on its covenants.<sup>124</sup> At the time of the transfer company's bankruptcy and thereafter, it was not in default. The trustee ultimately rejected the contract.<sup>125</sup> The hotel asserted a claim for damages in the transfer company's bankruptcy case. The trustee objected that the claim was not provable.<sup>126</sup>

The Court held that the debtor's bankruptcy constituted anticipatory breach of an implied promise. It noted that bankruptcy "strip[ped] the [debtor] of its assets," and "precluded its performance. . . ." Thus, "it must be deemed an implied term of every contract that the promisor will not permit himself, through insolvency or acts of bankruptcy, to be disabled from making performance. . . ."<sup>127</sup> The Hotel's claim was provable, even though technically contingent on the debtor's default at the time of the filing of the petition.<sup>128</sup>

The Court in dicta suggested that lessors' claims could be treated differently in bankruptcy than other anticipatory claims. The Court cited several lower court cases for the proposition that bankruptcy did not constitute anticipatory breach of contract. Among these were several real property lease cases.<sup>129</sup> As one commentator

123. See Schwabacher & Weinstein, *supra* note 32, at 239. At the time the Court decided *Chicago Auditorium*, bankruptcy of one party would probably not have constituted anticipatory repudiation under New York law. *Phoenix Nat'l Bank v. Waterbury*, 90 N.E. 435, 436 (N.Y. 1910).

124. 240 U.S. at 586-87, 36 S. Ct. at 412-13.

125. *Id.* at 587, 36 S. Ct. at 413.

126. The bankruptcy referee and the district court sustained the objection. *Id.* The court of appeals reversed and ordered the district court to allow a claim in the amount of loss incurred during the six months following the filing of the bankruptcy case on grounds that the contract permitted the hotel to terminate the contract on six months notice upon dissatisfactory service or change in hotel management. *Id.* The Court ultimately reversed the court of appeals to the extent that it limited the allowed amount of the hotel's claim to six month's worth of damages. The contract term that gave the hotel the right to terminate on six months notice was for its benefit and did not render the transfer company's performance conditional. *Id.* at 593-94, 36 S. Ct. at 415-16.

127. *Id.* at 591, 36 S. Ct. at 414-15.

128. Although the Court rendered the Hotel's claim non-contingent as a matter of law, the claim was unliquidated and as a practical matter, contingent on a variety of events yet to occur. Commentators at the time noted: "[N]o one could say what the actual loss suffered on reletting could be until the end of the contract term." Schwabacher & Weinstein, *supra* note 32, at 233.

129. *Colman Co. v. Withoft*, 195 F. 250 (9th Cir. 1912); *In re Roth & Appel*, 181 F. 667 (2d Cir. 1910); *In re Pennewell*, 119 F. 139 (6th Cir. 1902); *In re Ells*, 98 F. 967 (D. Mass. 1900). In *Chicago Auditorium*, the Court noted: "[lease cases] are distinguishable because of the 'diversity between duties which touch the realty, and the meere personalty [sic].'" 240 U.S. at 590, 36 S. Ct. at 414. See also William O. Douglas & Jerome Frank, *Landlord's Claims in Reorganizations*, 42 Yale L.J. 1003, 1004 n.6 (1933) (criticizing Supreme Court's historical observation); Radin, *supra* note 52, at 9-13, 16 (same).

observed: "This reassertion of the historical lease doctrine naturally cut down the efficacy of the decision as a foundation for new law on the provability of claims for future rent."<sup>130</sup>

The underlying motivation for the Court's holding in *Chicago Auditorium* may have been the desire to expand the scope of the discharge and thus the bankruptcy relief available to debtors under the Bankruptcy Act.<sup>131</sup> The Court may also have been influenced by the widespread availability of anticipatory relief in contract cases under state law.<sup>132</sup> The treatment of bankruptcy as an event of anticipatory breach achieved logical harmony with contractual theory.<sup>133</sup>

In any event, with the widespread acceptance of the doctrine of anticipatory repudiation and the Court's holding in *Chicago Auditorium*, it became more difficult to justify the non-provability of lessors' claims for lost profit on grounds that they were contingent at the time of the filing of the bankruptcy petition.<sup>134</sup> Even so,

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130. Richard C. Fuller, Comment, *Bankruptcy—Proof of Claims for Unaccrued Rent*, 32 Mich. L. Rev. 664, 666-67 (1934). The Court dealt another blow to the cause of provability for lessors' claims for lost profit in *Gardiner v. Butler*, 245 U.S. 603, 38 S. Ct. 214 (1918). This case involved a lessor's claim for lost profit in an equity receivership (as distinct from a bankruptcy case governed by Section 63a). After the receiver was appointed, the lessor reentered the premises and asserted a claim in the receivership for damages measured by the difference between rent reserved and rent on reletting. The lease contained no clause preserving the lessor's right to damages after reentry. The Court held the claim was not provable. The equity receivership of the tenant did not give the lessor rights greater than the lease itself gave. This conclusion is difficult to square with *Chicago Auditorium* decided two years earlier in which the Court held that bankruptcy constituted anticipatory repudiation giving rise to a right to anticipatory relief even when the contract in question was silent as to the effect of bankruptcy. The Court in *Gardiner* distinguished the result on grounds that lease relationships were historically distinct from ordinary contracts. *Id.* at 605, 38 S. Ct. at 214 ("[t]he law as to leases is not a matter of logic in vacuo; it is a matter of history that has not forgotten Lord Coke." *Id.*) *But see* *Filene's Sons Co. v. Weed*, 245 U.S. 597, 38 S. Ct. 211 (1918) (claim provable in equity receivership under language of lease).

131. In *Chicago Auditorium*, the Court noted that the purpose of bankruptcy laws was to "permit all creditors to share in the distribution of the assets of the bankrupt, and to leave the honest debtor thereafter free from liability upon previous obligations." 240 U.S. at 591, 36 S. Ct. at 415. Expansion of the range of provable claims enhanced creditors' rights, albeit minimally. Creditors of corporate debtors were better off with a chance for a dividend from the debtor's estate than a worthless right to enforce a nonprovable obligation against an empty, post-bankruptcy corporate shell. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. Colo. L. Rev. 845, 871 (1988).

132. At the outset of its opinion, the Court noted: "It is no longer open to question in this court that, as a rule, where a party bound by an executory contract repudiates his obligations or disables himself from performing them before the time for performance, the promisee has the option to treat the contract as ended, so far as further performance is concerned, and maintain an action at once for the damages occasioned by such anticipatory breach." 240 U.S. at 589, 36 S. Ct. at 414. Douglas and Frank observed that in the ten years preceding 1933, the trend in state courts was to extend the doctrine of anticipatory repudiation to lease damages claims. Douglas & Frank, *supra* note 54, at 1007 n.18. *See also* American Law of Property § 3.11 n.11 (1952).

133. Williston criticized the theory adopted in *Chicago Auditorium* as inconsistent with contractual theory. *See* 3 Samuel Williston, *The Law of Contracts* § 1327, 1987 (1920); 2 Samuel Williston, *The Law of Contracts* § 880 (1920). *See also* Restatement of the Law of Contracts § 315 (1932).

134. *See, e.g.,* Radin, *supra* note 52, at 7-9.



although lessors tried, their efforts to prove claims for lost profit in their tenants' bankruptcy cases continued to meet with failure.<sup>135</sup>

Parties to commercial leases honed their contracts to increase the chances that the lessor's claim for damages would be provable in the tenant's bankruptcy case. The key was to create a claim that was not contingent either as to existence or to amount as of the moment of the adjudication of the tenant's bankruptcy.<sup>136</sup> The first such claim to reach the Supreme Court was that in *Kothe v. R.C. Taylor Trust*.<sup>137</sup> The parties had entered into a two-year lease that provided that the filing of bankruptcy by the tenant shall "ipso facto" constitute a breach of the lease upon which the lessor shall be entitled to "damages for such breach in the amount equal to the amount of the rent reserved in the lease for the residue of the term thereof."<sup>138</sup> The trial court held the lessor's claim was nonprovable on grounds that it was contingent as of the filing of the tenant's petition in bankruptcy.<sup>139</sup>

The First Circuit reversed and held the claim provable under 63a(4) of the Bankruptcy Act.<sup>140</sup> Before the Supreme Court, the trustee argued that the damages claim, even if provable, was void as a penalty.<sup>141</sup> As a matter of federal common law, the Court held that the lessor's claim was void because it was based on an unenforceable stipulated damages provision.<sup>142</sup> The use of an ipso facto bankruptcy termination clause apparently removed the contingency that barred provability in *In re Roth & Appel*. But, the measure of damages stipulated by the parties in the lease in *Kothe* was supercompensatory, and thus unenforceable.<sup>143</sup>

The next year, in 1931, the Court addressed the question arguably left open after *Williams* as to whether a contingent contract claim (other than that of a surety

135. *E.g.*, *In re Goldberg*, 52 F.2d 156 (S.D. N.Y. 1931). Selective nonapplication of the doctrine of anticipatory repudiation to lease cases provoked dissent. *E.g.*, *In re Bissinger*, 5 F.2d 106, 111 (N.D. Ohio 1925), *rev'd sub nom.* *Wells v. Twenty-First St. Realty Co.*, 12 F.2d 237 (6th Cir. 1926).

136. Some courts during this period expressed hostility to contract clauses which appeared to be drafted to alter a common law result. *See, e.g.*, *In re Leslie & Griffith Co.*, 230 F. 465, 467 (D. Mass. 1916), *aff'd*, 251 F. 268 (1st Cir. 1918). *See also* Wolfgang S. Schwabacher & Sidney C. Weinstein, *Rent Claims in Bankruptcy*, 33 Colum. L. Rev. 213, 241 n.117 (1933) ("The common sense of courts has occasionally rebelled at allowing a claim which would have been rejected but for its verbal cloak.")

137. 280 U.S. 224, 50 S. Ct. 142 (1930).

138. *Id.* at 225, 50 S. Ct. at 142.

139. *Id.*

140. *Id.*

141. *Id.*, 50 S. Ct. at 143.

142. *Id.* at 226, 50 S. Ct. at 143. The Court noted the moral hazard problem inherent in enforcing promises that would affect the promisor only after he was insolvent. "The parties were consciously undertaking to contract for payment to be made out of the assets of a bankruptcy estate—not for something the lessee personally would be required to discharge. He, therefore, had little, if any, immediate concern with the amount of the claim to be presented; most probably, that would affect only those entitled to share in the proceeds of property beyond his control." *Id.* at 226-27, 50 S. Ct. at 143.

143. *Id.* Hostility to penal clauses is a departure from common law precedent where penal clauses in contracts were enforceable. 1 Woodfall on the Law of Landlord and Tenant 449 (A.J. Spencer ed., 22d ed. 1928). The federal courts generally rendered penalty stipulated damages clauses unenforceable in non-lease cases. *E.g.*, *Wise v. United States*, 249 U.S. 361, 39 S. Ct. 303 (1919); *Bassett v. Claude Neon Fed. Co.*, 65 F.2d 526 (10th Cir. 1933).

against its indemnitor) was provable under Section 63a(4).<sup>144</sup> In *Maynard v. Elliott*, the Court considered whether a creditor's claim against an endorser of commercial paper was provable notwithstanding that it was contingent upon presentment to and dishonor by the maker and notice of dishonor to the endorser as of the time of the filing. The Court noted without discussion: "[I]t is now settled that claims founded upon contract, which at the time of the bankruptcy are fixed in amount or susceptible of liquidation, may be proved under subdivision [63]a(4) . . . although not absolutely owing when the petition is filed."<sup>145</sup> The Court explained that not all contingent claims were provable. Rather, it was necessary to consider whether the liability of an endorser was among the class of contingent, but nonetheless provable contract claims.<sup>146</sup>

The Court held that a claim against an endorser was provable even though contingent because a more narrow construction of Section 63a(4) would contravene the basic rehabilitative policy of the Bankruptcy Act.<sup>147</sup> But, the Court carefully limited the scope of its opinion. A contingent claim would be *nonprovable* where the contingency is "beyond the control of the creditor, and dependent upon an event so fortuitous as to make it uncertain whether liability will ever attach"<sup>148</sup> or, if the contingency "make[s] any valuation of the claim impossible."<sup>149</sup> Thus, although *Maynard* expanded the range of provable claims to assist desperate debtors,<sup>150</sup> it expressly recognized that some contingent contract claims remained nonprovable under 63a(4).<sup>151</sup> Unfortunately for real property lessors, the Court in *Maynard* left a cloud of doubt about the effect of its decision on the provability of lessors' claims.

Contingency as to the existence of a lessor's claim virtually disappeared as a bar to provability after *Chicago Auditorium* and *Maynard*. The claims at issue in both *Chicago Auditorium* and *Maynard* were contingent as to liability. It was, and is, absurd to argue that one claim is more contingent than another contingent claim. Rights that are "more contingent" than the rights in these cases are not likely to be thought of as rights "founded upon a contract" in the first place, but rather as expectations.

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144. *Maynard v. Elliott*, 283 U.S. 273, 277, 51 S. Ct. 390, 391 (1931).

145. *Id.* at 275, 51 S. Ct. at 391 (citing to *Williams* and *Chicago Auditorium*).

146. *Id.* The view that an endorser's liability gave rise to a provable claim even though contingent on presentment, dishonor and notice of dishonor as of the time of the filing of the endorser's bankruptcy case generally prevailed among lower courts until *First National Bank v. Elliott*, 19 F.2d 426 (6th Cir. 1927). The Court explained that it accepted certiorari in *Maynard* to resolve a split the Sixth Circuit opinion had created among the circuits on this issue. 283 U.S. at 275, 276-77, 51 S. Ct. at 391-92.

147. 283 U.S. at 277, 51 S. Ct. at 391-92. One commentator noted that *Maynard v. Elliott* "legislated the contingencies of presentment and notice of dishonor out of existence by holding them unnecessary for charging the estate." Schwabacher & Weinstein, *supra* note 32, at 226.

148. 283 U.S. at 278, 51 S. Ct. at 392.

149. *Id.* (emphasis added).

150. The Court held the claim of a holder against a bankrupt endorser of a note was non-contingent both as to existence and amount, and thus provable. *Id.* at 279, 51 S. Ct. at 392.

151. *Id.* at 278, 51 S. Ct. at 392. See Douglas & Frank, *supra* note 54, at 1004 ("The reasoning and language of the Supreme Court in *Maynard v. Elliott* . . . is directly contrary to the reasoning of the court in *In re Roth & Appel* . . .").

Although claim contingency was not a bar to provability, the perceived problem of liquidating lessor's claim for lost profit before expiration of the lease term at least arguably remained as a bar.<sup>152</sup> Three years after *Maynard*, in *Manhattan Properties v. Irving Trust Co.*,<sup>153</sup> the Court again considered the provability of a lessor's claim for lost profit. The Court held in two consolidated cases that lessors' claims based on a tenant/debtor's breach of indemnity covenants were not provable. In the first case, the lease contained a covenant that gave the lessor the right to reenter the premises upon the tenant's default or abandonment if the tenant should become insolvent or make an assignment for the benefit of creditors.<sup>154</sup> After reentry, the lessor could relet the premises for the account of the tenant. The tenant further agreed to pay each month the difference between rent due under the original lease and the rent which the lessor might obtain by reletting.<sup>155</sup> The relevant covenant in the second case was essentially the same.<sup>156</sup>

The Second Circuit below had held that *In re Roth & Appel* governed and granted the trustee's motions to disallow both claims as nonprovable.<sup>157</sup> Judge Hand writing for the Second Circuit expressed his view that *Maynard v. Elliott*<sup>158</sup> and *Chicago Auditorium*<sup>159</sup> rejected the notion that contingency of a claim or difficulty of estimation of the present value of payments to be made in the future necessarily barred provability.<sup>160</sup> But, the Second Circuit, nonetheless, held in favor of the

152. Contingency regarding the existence of a claim and contingency regarding the amount of the claim if it exists are inextricably related. See Schwabacher & Weinstein, *supra* note 32, at 233. In the case of the claim of a lessor for lost profit, if the lessor is to have such a claim at all, the market value of the leased premises must be less than the rental value over the relevant term. Once this contingency is rendered irrelevant to provability, the lessor must still establish the fact of liability and the magnitude of loss to liquidate the claim.

153. 291 U.S. 320, 54 S. Ct. 385 (1934).

154. *Id.* at 328, 54 S. Ct. at 385.

155. In what was probably a heavily negotiated clause, the tenant agreed:

to pay each month to the Landlord the deficit accruing from the difference between the amount to be paid as rent as herein reserved and the amount of rent which shall be collected and received from the demised premises for such month during the residue of the term herein provided for after the taking possession by the Landlord; the overplus, if any, at the expiration of the full term herein provided for shall be paid to the Tenant unless the Landlord within a period of six months from the termination of this lease as provided herein shall, by a notice in writing, release the Tenant from any and all liability created by this provision of the lease, which it is agreed the Landlord shall, at the Landlord's option, have the right to do, in which event it is agreed that the Landlord and the Tenant shall have no further rights and liabilities hereunder.

*Id.* at 328-29, 54 S. Ct. at 386.

156. In that lease, the lessor had the right to reenter the premises upon the tenant's default or if the tenant should be adjudicated a bankrupt. If the lessor did reenter, the tenant promised to "indemnify the Lessor against all loss of rent which the Lessor may incur by reason of such termination, during the residue of the term above specified." *Id.* at 329, 54 S. Ct. at 386.

157. *Manhattan Properties v. Irving Trust Co.*, 66 F.2d 470 (2d Cir. 1933).

158. 283 U.S. 273, 51 S. Ct. 390 (1931), discussed in *supra* note 144 and accompanying text.

159. 240 U.S. 581, 36 S. Ct. 412 (1916), discussed in *supra* notes 130-133 and accompanying text.

160. *Manhattan*, 66 F.2d at 471-72 ("For myself . . . it seems to me that the basis of the doctrine disappears once contingent claims are held to be provable. That has now been authoritatively declared, and I think that we should make the necessary adjustments."). Ironically, the Seventh Circuit had held

trustee on the ground that *In re Roth & Appel* somehow survived. Although contingent claims founded on contract could in general be proved, lessors' claims for lost profit could not be liquidated without speculation, and thus remained non-provable.<sup>161</sup> The Second Circuit thus abandoned any pretense that the unique nonprovability of lessors' claims for lost profit derived from a historical feature of real property lease law.

Before the Supreme Court, the lessors argued that if their claims for lost profit were non-provable, individual debtors would be denied the benefit of discharge, and lessors to corporate debtors would unfairly be relegated to chasing an empty corporate shell for satisfaction of their claims.<sup>162</sup> The trustee argued that the lessor's claims for rent ought to be nonprovable based on legislative history and judicial construction that preponderately excluded lessor's claims for lost profit from the class of provable debts.<sup>163</sup>

The Court recounted the treatment of lessor's claims for unaccrued rent over the course of English and American bankruptcy law.<sup>164</sup> It concluded that the failure to expressly provide for the provability of lessors' claims for unaccrued rent "is significant of an intent not to depart from the precedents disallowing them."<sup>165</sup> The Court also noted that federal courts construing Section 63a "uniformly held such claims were not provable debts."<sup>166</sup> It cited to its opinion in *Chicago Auditorium* as support for the proposition that it had neither passed on the provability of lessor's claims for accelerated rent nor disapproved the rulings of lower federal courts excluding such claims from proof.<sup>167</sup>

The Court characterized the claims in the cases before it as claims for unaccrued rent, and not for damages arising from breach of indemnity covenants.<sup>168</sup> Under the

two days earlier that a proof of claim for damages under a similar indemnity covenant was provable. *In re National Credit Clothing Co.*, 66 F.2d 371 (7th Cir. 1933).

161. *Manhattan*, 66 F.2d at 471. Hand noted the obvious fallacy in this reasoning after *Chicago Auditorium*. *Id.* See also Note, *Provability of Future Rent Claims in Bankruptcy*, 47 Harv. L. Rev. 488, 491-92 (1934).

162. *Manhattan Properties v. Irving Trust Co.*, 291 U.S. 320, 331-32, 54 S. Ct. 385, 387 (1934).

163. *Id.* at 332, 54 S. Ct. at 387.

164. *Id.* at 332-34, 54 S. Ct. at 387-88. The Court noted that although lessor's claims for lost profit were originally nonprovable under English law, they were rendered provable by statutory enactment in 1869. *Id.* at 332, 54 S. Ct. at 387. In summary the American Bankruptcy Acts of 1800 and 1841 permitted proof of some contingent claims but did not specifically mention a lessor's claim for lost profit. Courts construing these acts found lessors claims non-provable on grounds that they were contingent as to occurrence and not susceptible of liquidation prior to the expiration of the term. *Id.* at 332-34, 54 S. Ct. at 387-88. The Bankruptcy Act of 1867 specifically authorized proof of a claim for rent due up to the date of bankruptcy, but was silent as to claims for lost profit. Courts under this Act held that lessors' lost profit claims did not fall within the statutory definition of "contingent" claims. Other courts held that the specific provision for claims for past due rent precluded proof of lost profit. *Id.* at 333-34, 54 S. Ct. at 387.

165. *Id.* at 335, 54 S. Ct. at 388.

166. *Id.*

167. *Id.* at 336, 54 S. Ct. at 388.

168. *Id.* at 337, 54 S. Ct. at 389. The Court wrote:

In both cases, the lessor has the choice whether he will terminate the lease. . . . And upon the exercise of the option by the landlord, a new contract, distinct from that involved in the

leases, the tenants' obligation to indemnify only came into being by exercise of the lessors' option to reenter upon bankruptcy. The lessors could reenter only *after* the filing of the tenants' petition. Thus, as of bankruptcy, no obligation to indemnify existed and none was breached. The lessors' claims were solely for future rent, contingent as of the date of the filing of the petition, and for that reason, nonprovable.

The Court's careful parsing of the terminology of the lease covenants presented in *Manhattan Properties v. Irving Trust* was music to the ears of alert real estate lawyers. By deciding the provability of these claims by scrupulous examination of the lessors' rights under the respective leases, the Court preserved the possibility that careful drafting could yield a provable claim for lost profit.<sup>169</sup>

Lessors' lawyers hit the jackpot in late 1934. A lessor finally succeeded in proving a claim for lost profit in *Irving Trust Co. v. A.W. Perry*.<sup>170</sup> Like the lease in *Kothe*, the lease defined the filing of a petition in bankruptcy as, ipso facto, a breach and termination of the lease.<sup>171</sup> Upon such termination, the lessor was immediately entitled to damages equal to rent reserved, less the fair rental value of the premises for the remaining term.<sup>172</sup> The Second Circuit below had held that the lessor's claim was provable and the trustee appealed.<sup>173</sup>

The Supreme Court in a brief opinion, affirmed the Second Circuit. The claim in question "arose and matured at the moment of the filing of the petition."<sup>174</sup> Unlike the claim for damages in *Manhattan Properties*,<sup>175</sup> the lessor's claim was not contingent on the lessor's exercise of its right of reentry. Moreover, the measure of damages stipulated in the lease, which reduced reserved rent by the fair rental value of the premises, was not a penalty but rather "a reasonable formula for ascertaining the damages of the landlord."<sup>176</sup>

original letting, becomes operative. While there is some color for the claim that bankruptcy is an anticipatory breach of the lease contract, entailing a damage claim against the estate, this cannot be true as respects these independent covenants of indemnity.

*Id.* at 338, 54 S. Ct. at 389.

169. See Comment, *supra* note 130, at 668-69. One commentator criticized the outcome: "The far-sightedness of counsel for one landlord in inserting a particular type of damage covenant is hardly sufficient reason to allow him to prove in full, while another landlord, less ably advised, is denied proof of any claim, since the real intention of both is, in practice, about the same." Note, *supra* note 161, at 493. See also Note, *Congress Determines the Provability of Claims For Future Rent In Bankruptcy*, 22 Va. L. Rev. 199, 201-03 (1935) (discussing particular lease clauses and their effect). Another commentator speculated that the Court was aware of the economic significance of its decision and chose to punt to Congress. Comment, *supra* note 130, at 671. See also Martin A. Roeder, *Landlords, Bankruptcy, and 77B*, 23 Cornell L. Q. 285, 289 (1938).

170. 293 U.S. 307, 55 S. Ct. 150 (1934).

171. *Id.* at 309-10, 55 S. Ct. at 150. Apparently, ipso facto clauses were relatively uncommon in leases at that time. See Douglas & Frank, *supra* note 54, at 1006.

172. *Id.* at 310, 55 S. Ct. at 150. See also *In re Outfitters' Operating Realty Co.*, 69 F.2d 90, 91 (2d Cir. 1934).

173. *A.W. Perry v. Irving Trust Co.*, 69 F.2d 90, 91 (2d Cir. 1934).

174. *Irving*, 293 U.S. at 311, 55 S. Ct. at 150-51.

175. See *supra* discussion notes 153-157, 160-168 and accompanying text.

176. *Irving*, 293 U.S. at 311, 55 S. Ct. at 151. See also *Filene's Sons Co. v. Weed*, 245 U.S. 597,

*Perry* rendered legally distinct lessors' claims for rent (non provable) and for damages for breach of an indemnity covenant (provable). Any historically-based proposition that lessors' claims ought be non-provable in bankruptcy was officially defunct. A lessor could prove a claim for damages in his tenant's bankruptcy proceeding provided his lease contained an indemnity covenant that was appropriately drafted to eliminate contingency as to the existence and speculation as to the amount of his claim.<sup>177</sup>

The possibility that a lessor's claim for damages might be provable in a tenant's bankruptcy case created two problems that prior treatment of lessors' claims as nonprovable had always avoided. First, once lessors' claims for lost profit became provable, federal courts would be called upon to liquidate them, notwithstanding uncertainty regarding market conditions over the remaining term.<sup>178</sup> Second, and related, permitting a lessor to prove its claim in the bankruptcy case would necessarily, and in many cases drastically, reduce the expected dividend to non-lessor creditors.

During a period of severe economic depression, assigning a present value to a leasehold, particularly one with a long remaining term, is imprecise at best.<sup>179</sup> Those holding an optimistic view of economic recovery would contend that the market value of real property can only increase over the remaining term of the lease.<sup>180</sup>

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38 S. Ct. 211 (1918) (in an equity receivership, lessor's claim for lost profit valued as reserved rent less rental value).

177. One year after *Perry*, the Court in *Miller v. Irving Trust Co.*, 296 U.S. 256, 56 S. Ct. 189 (1935), held a lessor's claim under a slightly different indemnity clause for lost profit was not provable. The lease in question provided that if the tenant abandoned the premises, the lessor could reenter and relet for the account of the tenant, with the tenant liable for rent less substitute rent "on demand or as it accrues from month to month." *Id.* at 257-58, 56 S. Ct. at 190. During the term of the lease, an equity receiver was appointed for the tenant. The receiver took possession of the premises, then later disaffirmed the lease whereupon the lessor reentered the premises. *Id.*, 56 S. Ct. at 189. The tenant filed for bankruptcy relief about one month later. *Id.* The lessor then relet the premises for the balance of the term for less than the original rent. The lessor's lost profit claim was not provable in the tenant's bankruptcy case because under the indemnity covenant the lessor's damages were measured by what actually transpired upon reletting. In *Perry* the lessor was entitled to recover the difference between the present value of reserved rent and rent on reletting. The Court in *Miller* refused to interpret the indemnity covenant in the lease at issue as measuring damages based on the present values of reserved rent and an estimate of the present market value of the premises. Because the Court found the lessor's damages in *Miller* were impossible to liquidate under the covenant at issue, the lessor's claim was not provable. *Id.* at 258, 56 S. Ct. at 190 (under the clause in question it was, as of the filing, "a mere matter of speculation[,] whether any liability would ever arise under it."

178. The court could postpone liquidation of the claim until the contingencies are resolved, or it could estimate the present value of such claims given the contingencies. See generally Schwabacher & Weinstein, *supra* note 32, at 226-27. The first method impairs the speedy administration of a bankrupt estate. The second method puts the contingent claimant on par with those creditors whose claims are noncontingent. Schwabacher and Weinstein observed that the second method would irk noncontingent claimants. *Id.* at 228.

179. See generally Radin, *supra* note 34, at 568, 570. Professor Radin proposed an auction of the unexpired term of the lease as the solution to the damages valuation problem.

180. Optimism appeared to prevail at least among scholarly commentators at the time. One commentator noted: "Since the frequency of bankruptcies is highest during severe economic depression, when the rental value of property is at low ebb, it is probable that property values will rise

Those with a darker view would contend that the bottom of the trough has not yet been reached. Valuation of property during the depression of the 1930's thus involved allocating between the lessor and the tenant/debtor's other creditors the risk that economic recovery was not just around the corner. Valuation of the leased property at its "low" market value would yield a large lost profit claim for the lessor and would shift the cost of economic nonrecovery on non-lessor creditors.<sup>181</sup> Conversely, assigning a "high" market value would yield a low lost profit claim for the lessor and would shift the risk of delayed economic recovery to the lessor.

During the Thirties, the provability of real property lessor's claims for lost profit was a significant economic issue.<sup>182</sup> Provability in full of lessors' claims and the potential for lessors to overrun insolvency proceedings to the detriment of other creditors was clearly a concern for courts.<sup>183</sup> On the other hand, lessors were outraged at the ability of their tenants to use the nonprovability of the lessor's claim as a means to strip down liability.<sup>184</sup> In a 1933 article in the Yale Law Journal,

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before the end of the period of the long-term lease. Consequently, a claim for the difference between the rent reserved and the rental value at the time of the filing of the petition, properly discounted, may have very little relation to the damage actually suffered by the lessor." Comment, *supra* note 130, at 670. Cf. Robert T. Swaine, *A Decade of Railroad Reorganization Under Section 77 of the Federal Bankruptcy Act*, 56 Harv. L. Rev. 1037, 1056 (1943) (observing that the Interstate Commerce Commission delayed in administering railroad reorganizations during 1933-35 "until it felt that the new lower levels [of railroad earnings] evidenced a permanent trend from which there was little hope of recovery to earlier levels.").

181. An insolvent tenant externalizes loss he would otherwise bear to his creditors as a group. Absent a different rule, creditors with the same priority participate pro-rata (on the basis of their claims) in distribution with other creditors, and they bear loss pro-rata. To the extent that bankruptcy law disallows all or part of a lessor's claim (as determined under state law), such lessor is disadvantaged *vis-a-vis* other creditors and bears a disproportionate share of the externalized loss relative to a pro-rata allocation. See *supra* discussion notes 9-13 and accompanying text.

182. *Manhattan Properties* "threw into high relief the plight in which landlords found themselves as a result of the flood of corporate bankruptcies brought about by the economic depression." *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 438, 57 S. Ct. 292, 294 (1937). Commentators noted: "At the heart the problem is a business and economic one. . . . [G]rim economic necessity requires that rent not exceed a certain percentage of gross revenue; in periods of falling prices, declining sales and deep economic depression, financial readjustment is a prime necessity." Douglas & Frank, *supra* note 54, at 1008.

183. In *In re Collington*, 4 A.B.R. 250, 254 (1900), the court expressed its concern that provability of the lessor's claim for damages might squeeze out other creditors of the estate. It commented: "Any other ruling . . . would not merely tempt landlords to drag out the administration of estates in bankruptcy, but often make it possible for them, through eleventh hour claims for vacant premises or on fictitious relettings, materially to reduce the dividends of other creditors . . ." *Id.*

184. "The situation of owners of business properties leased to chain store organizations which had resorted to voluntary bankruptcy largely as a lever to force revision of leases was the subject of comment in and out of Congress." *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 438, 57 S. Ct. 292, 294 (1937). For an example of judicial outrage at the strategy of using bankruptcy to strip down lessors' claims, see *May Hosiery Mills, Inc. v. F. & W. Grand 5-10-25 Cent Stores, Inc.*, 59 F.2d 218, 220 (D. Mont. 1932), *rev'd*, 64 F.2d 450 (9th Cir. 1933) (denying petition for receivership and fining local counsel for the petitioning debtor for contempt: "employment of the judicial club to beat off and hold up creditors until, wearied, they settle with or wait the pleasure of the debtor's executive vice president receiver shielded by the judicial gown.").

Professors William Douglas and Jerome Frank observed that bankruptcy "has been frequently condemned in popular thought as constituting nothing but a racket which ingenious counsel have devised as an avenue to escape from just obligations."<sup>185</sup>

### C. The "Limited Sacrifice"

At the beginning of the 1930's, the scope of bankruptcy relief presented Congress with a stark political problem. Individuals seeking relief in bankruptcy were chagrined to find their obligations under real property leases dogging them even after discharge. Lessors also were not pleased with their fate. Commentators observed with understatement: "It is, of course, not unnatural for landlords to find little comfort in their theoretically undischarged rights against defunct corporations when they are excluded from sharing in the assets."<sup>186</sup>

As early as 1932, Congress began considering changes to the bankruptcy laws to respond to this problem and severe economic dislocation generally.<sup>187</sup> By the Act of March 3, 1933, Congress enacted Section 74 to the Bankruptcy Act.<sup>188</sup> It permitted individual debtors to work out their financial problems as an alternative to total liquidation of their nonexempt assets. The last sentence of Section 74(a) specifically provided for the provability of real property lessors' claims for lost profit in these reorganization proceedings.<sup>189</sup> In the same Act, Congress enacted Section 77, which provided for the reorganization of railroad debtors.<sup>190</sup> The last sentence of Section 77(b) was virtually identical to that in Section 74, and similarly rendered provable railroad real property lessors' claims for lost profit.<sup>191</sup>

185. Douglas & Frank, *supra* note 54, at 1003. The authors noted that while bankruptcy sparked abuse, some response to insolvency was essential in light of the depression. "Falling prices and declining sales make necessary . . . a readjustment if the business is to continue as a going concern." *Id.*

186. Schwabacher & Weinstein, *supra* note 32, at 213-14 ("[C]hain store bankruptcies engineered more or less openly for the purpose of escaping burdensome leases without compensating the landlords, have awakened interest in the status of claims in bankruptcy for rent accruing after the filing of the petition.").

187. In the 72d and 73d Congress, Congress considered several ultimately unsuccessful bills which would have authorized proceedings for the reorganization of business corporations. See *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 438, 57 S. Ct. 292, 294 (1937).

188. Act of March 3, 1933, ch. 204, 47 Stat. 1467, 1468 (repealed 1978) (hereinafter 1933 Amendment).

189. The relevant language read: "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." *Id.* See generally Schwabacher & Weinstein, *supra* note 32, at 213. See also Cong. Rec., Senate, Feb. 24, 1933, pp. 5058, 5059; Feb. 27, 1933, p. 5278.

190. 47 Stat. 1467, 1474 (1933). See generally Churchill Rodgers & Littleton Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act*, 33 Colum. L. Rev. 571, 572 (1933); Swaine, *supra* note 180, at 1038; 5 *Colliers on Bankruptcy* (14th ed. 1940).

191. 47 Stat. 1467 (1933).



By the Act of June 7, 1934, after the Court's decision in *Manhattan Properties* but a few months before *Irving Trust v. A.W. Perry*,<sup>192</sup> Congress amended the Bankruptcy Act to include Section 77B, which provided for non-railroad, corporate reorganization.<sup>193</sup> It defined "creditor" to include holders of claims under executory contracts, regardless of whether such claims would have been provable under prior law. The effect was to render provable previously non-provable, contingent claims. But, the allowed amount of a real property lessor's claim for lost profit was capped at three year's worth of reserved rent.<sup>194</sup>

In the same Act of June 7, 1934, Congress amended Section 63a which governed the provability of claims in liquidation cases.<sup>195</sup> Like the treatment of lessors' claims in 77B, lessors' lost profit claims became expressly provable subject to a capped amount of one year's worth of reserved rent.<sup>196</sup>

Sections 63a(7) and 77B(b)(10) rendered provable lessors' claims "for injury resulting from the rejection [by the trustee] of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease. . . ."<sup>197</sup> Statutory provability of lessors' claims had several effects. First, the tenant's bankruptcy constituted a total repudiation of the lease, codifying for lessors' claims the result in *Chicago Auditorium*.<sup>198</sup> Following from this proposition, a lessor obtained a statutory claim for damages resulting from the estate's rejection of an unexpired lease even where the lease did not contain an indemnity covenant.<sup>199</sup> In such a case, the Court implied the measure of the lessor's damages (prior to application of the cap) as "the difference between the rental value of the remainder of the term and the

192. See *supra* discussion notes 170-176 and accompanying text.

193. Act of June 7, 1934, ch. 424, 48 Stat. 911 (1934).

194. *Id.* Section 77B(b)(10):

The claim of a landlord 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 be treated as a claim ranking on a parity with debts which would be provable under section 63(a) of this Act, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid rent accrued up to such date of surrender or reentry.

195. 48 Stat. 923, ch. 424, § 4 (1934).

196. Debts of the bankrupt may be proved and allowed against his estate which are . . . (7) claims for damages respecting executory contracts including future rents whether the bankrupt be an individual or a corporation, but the claim of a landlord for injury resulting from the rejection by the trustee 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 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. . . .

*Id.*

197. Section 63a(7), 47 Stat. 1467 (1934); Section 77B(b)(10), 48 Stat. 911 (1934).

198. See *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 440, 57 S. Ct. 292, 295 (1937).

199. *Id.* at 443, 57 S. Ct. at 297 (provability of a claim for damages upon rejection of a lease is not affected by post-rejection conduct that would have terminated the lease under state law.)

rent reserved, both discounted to present worth."<sup>200</sup> Because calculation of the lessor's damages took into account the present rental value of the premises following rejection, the lessor must be entitled to reenter the property following rejection without losing his bankruptcy claim, even if reentry would terminate the lease (and the lessor's rights against the tenant) under non-bankruptcy law.<sup>201</sup>

In 1938, Congress passed the Chandler Act which further amended the treatment of lessors' lost profit claims in liquidation cases.<sup>202</sup> The amendment did not materially change the effect of the prior law on the allowability of lessor's lost profit claims.<sup>203</sup>

Scholarly commentators characterized the new law governing lessors' claims as an improvement for lessors.<sup>204</sup> Certainly a lessor who could have proven his claim in full under prior law was not better off.<sup>205</sup> The inescapable effect of the amendments on both lessors and tenants was to reduce their ability to allocate risk by contract. No lessor regardless of the terms of his lease, or the magnitude of his damages under nonbankruptcy law, could assert a lost profit claim in his tenant's bankruptcy case for more than the statutory maximum amount.<sup>206</sup>

200. *Id.*

201. *Id.* at 444, 57 S. Ct. at 297. If prior to the tenant's bankruptcy, a lessor had terminated the lease without a surviving indemnity clause, or had otherwise released his nonbankruptcy law rights against the tenant, the lessor would have no claim against the debtor tenant. See *Schwartz v. Irving Trust Co.*, 299 U.S. 456, 57 S. Ct. 303 (1937); *Meadows v. Irving Trust Co.*, 299 U.S. 464, 57 S. Ct. 307 (1937).

202. The amendment deleted subparagraph (7) and inserted subparagraphs (8) and (9). Paragraph (8) expressly rendered provable "contingent debts and contingent contractual liabilities." Paragraph (9) rendered claims for anticipatory breach of executory contracts expressly provable with the limitation that a lessor's claim for:

damages or injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in the 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 to the landlord or the date of re-entry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued without acceleration, up to such date.

Act of June 22, 1938, ch. 575, 52 Stat. 840.

203. *Id.* The Chandler Act restricted real property lessors' liens for rent, except as against certain other liens. 52 Stat. 840, 876 (1938) (§§ 67b and c).

204. *E.g.*, Edwin S. Newman, *Rent Claims In Bankruptcy and Corporate Reorganization*, 43 Colum. L. Rev. 317, 319-20 (1943); Note, *supra* note 169, at 204 (describing amendments as a "happy compromise"); David E. Bennett, *The Modern Lease—An Estate in Land or a Contract (Damages for Anticipatory Breach and Interdependency of Covenants)*, 16 Tex. L. Rev. 47, 61 (1937) (rule "makes for greater certainty . . . and is a definite improvement. . ."). 3A Collier on Bankruptcy 1894 (14th ed. 1941) ("The statutory solution represented a happy medium and imposed on the creditors a limited sacrifice in order to achieve the desirable end of facilitating the debtor's rehabilitation by extending the scope of his discharge."). See also *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 438, 57 S. Ct. 292, 294 (1937).

205. Lessors with claims like the one held provable in *Perry* were substantially worse off. See *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 57 S. Ct. 298 (1937).

206. See, *e.g.*, 3 Collier on Bankruptcy 1881-1907 (14th ed. 1941); Newman, *supra* note 204, at 320, but see Roeder, *supra* note 169, at 289.

Despite commentary lauding the amendments, lessors were not pleased, and did not see the justice of their sacrifice. In *Kuehner v. Irving Trust Co.*,<sup>207</sup> a lessor challenged the constitutionality of the cap on lessors' claims in Section 77B(b) governing corporate reorganizations. In 1926, the lessor entered into a twenty-year lease of retail space with United Cigar Stores. Six years later, in 1932, United Cigar filed for bankruptcy relief.<sup>208</sup> The trustee rejected the lease and abandoned the premises to the lessor. The lease permitted the lessor to terminate upon abandonment and hold the tenant liable for resulting loss. Two days after the effective date of Section 77B (reorganization), the debtor filed a new case for relief under that section.<sup>209</sup> The lessor filed a claim in the new case for damages equal to the difference between the reserved rent and rental value of the subject premises for the remaining term.<sup>210</sup> The court capped the allowed amount of the lessor's claim at three years of reserved rent as required by 77B(b).<sup>211</sup>

The lessor requested that any portion of its claim disallowed under Section 77B(b) be granted priority over stockholders' claims. The Court held that the lessor's entire claim was affected by Section 77B(b) and no part of his nonbankruptcy law rights survived to compete with equity interests. The disallowed portion of the lessors' claim was entirely disallowed even against the interests of stockholders.<sup>212</sup>

The lessor argued that the imposition of the cap exceeded Congress' power to make bankruptcy laws, and constituted a taking of its property without due process of law.<sup>213</sup> Without discussion, the Court held that the disallowance of lessors' claims was indeed within the Legislature's constitutional power to make laws affecting bankruptcy.<sup>214</sup> Nor did Section 77B(b) deny lessors due process of law. The Court declared that the cap on lessors' claims was rational. It considered the history of the treatment of real property lessors' claims, and held that Congress must have imposed the cap on lessors' claims as a middle ground between two equitably

207. 299 U.S. 445, 57 S. Ct. 298 (1937).

208. *Id.* at 447, 57 S. Ct. at 299.

209. *Id.*

210. The fair rental for the remaining term was \$111,545. The reserved rent was \$199,237, for a difference of \$87,692. Three years worth of rent was \$44,377. *Id.* at 448, 57 S. Ct. at 300.

211. *Id.*

212. *Id.* at 450, 57 S. Ct. at 300-01. See *Douglas & Frank*, *supra* note 54 (arguing for imposition on reorganized corporations of successor liability to lessors to the extent of their nonprovable claims under *Northern Pacific Ry. Co. v. Boyd*, 228 U.S. 482, 504, 33 S. Ct. 554, 560 (1913)). See also *in re Federated Dep't Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991).

213. 299 U.S. at 450, 57 S. Ct. at 300-01.

214. *Id.* at 451, 57 S. Ct. at 301. Two years earlier, the Supreme Court had held the Frazier-Lemke Act unconstitutional on grounds that it worked an unconstitutional taking of farm mortgagees' property rights. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 55 S. Ct. 854 (1935). The lessors in *Kuehner* argued that the cap in Section 77B violated the Fifth Amendment in the same way as the Frazier-Lemke Act did. The Court distinguished *Radford* on grounds that the rights unconstitutionally eliminated by the Frazier-Lemke Act were liens. Section 77B impaired only contract rights as opposed to property interests. *Kuehner*, 299 U.S. at 452, 57 S. Ct. at 301-02 ("[T]here is, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract since the Constitution does not forbid impairment of the obligation of the latter.").

unacceptable alternatives: 1) treating lessors claims as provable and fully allowable; or 2) treating such claims as nonprovable. Under the first alternative, lessors would command "too much" of the debtor's estate relative to other creditors. Alternatively, treating lessors' claims as nonprovable would yield an "inadequate" discharge for the debtor.

The Court indicated concern about liquidating lessors' lost profit claims during an economic depression. It noted that evidence regarding the market value of the leased premises: "partakes largely of the character of prophesy. . . . Add to this the fact that bankruptcies multiply in hard times, and that estimates of rental value are made upon the basis of what a new tenant will pay in an era of economic depression, and the estimate becomes even more unreliable. . . ." Ultimately the Court held that Congress could "not unreasonably" have determined that "an award of the full difference between rental value and rent reserved for the remainder of the term smacks too much of speculation and that a uniform limit upon landlords' claims will, in the long run, be fair to them, to other creditors, and to the debtor."<sup>215</sup> The statutory cap on lessors' claims replaced an "old remedy inefficient and uncertain in its result" with a "new and more certain remedy for a limited amount."<sup>216</sup> The cap of three years was not arbitrary but rather gave a lessor a "reasonable chance of restoring himself to as good a position as if the lease had not been terminated."<sup>217</sup> Moreover, real property lessors could rationally be treated differently than other unsecured creditors because, in the view of the Court, lessors' rights against the debtor/tenant were different than other creditors' rights. Lessors got their property back.<sup>218</sup>

Seven years later, in *Oldden v. Tonto Realty Corp.*,<sup>219</sup> the Second Circuit applied Bankruptcy Act section 63a(9) to limit a lessor's allowed claim for lost profit. The court set out what was to become an influential summary of the history of Section 63a(9).<sup>220</sup> The "limited sacrifice" required of lessors by Section 63a(9) embodied an "obvious compromise between various conflicting interests . . . and was reached only after serious research and study on the part of the legislators."<sup>221</sup>

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215. *Kuehner*, 299 U.S. at 450, 57 S. Ct. at 300-01. The idea echoed by the Court that lessors did not expect to enforce their nonbankruptcy law right to damages, and would not be unconstitutionally deprived by a statute to that end, may have motivated statutory provability subject to maximum caps in the 1934 amendment to the Bankruptcy Act. In a 1933 scholarly article, commentators obliquely described the "feeling" that long term lessors "probably do not contemplate coming in as creditors for a large lump sum. . . ." They noted at that time that "it has been suggested that the statute be amended to allow damages for a limited period, e.g., five years, but to discharge the entire claim." Schwabacher & Weinstein, *supra* note 32, at 238 n.104.

216. *Kuehner*, 299 U.S. at 453, 57 S. Ct. at 302. See *supra* note 214 and accompanying text.

217. *Id.* at 455, 57 S. Ct. at 303.

218. *Id.* ("[Lessors] have lost merely a bargain for the use of real estate whereas merchandise creditors, lenders, and others, recover in specie none of the property or money which passed from them to the debtor.").

219. 143 F.2d 916 (2d Cir. 1944).

220. *Id.* at 918. The portion of the Senate Report on Section 502(b)(6) cites approvingly to the Second Circuit's historical summary in *Oldden*. S. Rep. No. 95-989 at 353-54 (1978), *reprinted in*, 1978 U.S.C.A.N. 6309.

221. *Id.* at 920.

The conflict was between full provability of lessors' claims and complete nonprovability. Nonprovability of lessors' claims was unacceptable to lessors who after bankruptcy were left holding the bag against defunct corporations. Full provability, although "easily justified on technical legal grounds"<sup>222</sup> was unattractive from a policy standpoint.<sup>223</sup> Lessors' claims if provable could potentially be sufficiently large to thwart the "main object" of the Bankruptcy Act, which was "rehabilitation of the honest debtor."<sup>224</sup> Perhaps more importantly, full provability of lessors' claims would come at the expense of other creditors.<sup>225</sup> The court then observed without empirical reference that lessors' claims if allowed would tend to be overcompensatory. "[Lessors'] claims . . . would often be disproportionate in amount to any actual damage suffered, particularly in the event of a subsequent rise in rental values."<sup>226</sup>

The Second Circuit further explained that lessors' claims could fairly be disallowed while other creditors' claims were allowed in full. "In truth, the landlord is not in the same position as other general creditors, and there is no very compelling reason why he should be treated on a par with them."<sup>227</sup> The court reiterated the Supreme Court's observation in *Kuehner*: lessors got their property back, while other creditors had no recourse to property.<sup>228</sup> The Second Circuit then added its own flourish. A lessor's claim for damages could be disallowed in part because the unexpired term of the lease "in no way benefits the assets of the bankrupt's estate."<sup>229</sup>

At issue in *Odden* was the effect of a security deposit held by the lessor on the lessor's allowed claim under the cap. The trustee argued that the security deposit should reduce the capped amount of the lessor's claim. The lessor argued that the security deposit should reduce his claim as calculated under the lease, prior to application of the cap.<sup>230</sup> The Second Circuit held that the security deposit should reduce the lessor's post-cap claim.<sup>231</sup> The effect of the ruling was to enrich non-lessor creditors at the expense of the lessor.<sup>232</sup> And this effect was consistent with the purpose of the statute.

In a scathing opinion, the dissent disputed the majority's characterization of the purpose of the statute:

222. *Id.* at 919.

223. The court noted that provability prior to the amendment to Section 63a(9) "made landlords' claims depend on the niceties of ancient property law, rather than on the practical aspects of modern business." *Id.* at 919. Actually, the provability of lessors' claims at that time depended on whether the parties had adopted specific express terms in their agreement providing for an ipso facto damages claim on the tenant's bankruptcy. This condition came about not because of "the niceties of property law" but from courts' irrational hostility to lessors' damages claims.

224. *Id.* at 920.

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.* & n. 9 (citing *Kuehner*).

229. *Id.*

230. *Id.* at 917-18.

231. *Id.* at 920.

232. *Id.* at 918.

But I cannot agree with my colleagues that Congress . . . designed to unfeudalize the law of leases and to do some justice to landlords without injuring the other creditors of lessees—was activated by any Henry Georgian animosity to owners of land. It is difficult for me to believe that Congress has become so collectivist-minded, so opposed to the common characteristics of our profit system, that it intended that a landlord should not (to quote my colleagues) “obtain an advantage merely because he has been shrewd or economically powerful enough to have obtained a substantial deposit as security” and that landlords should not “receive different treatment . . . depending upon the existence and size of the securities in their possession.”<sup>233</sup>

Notwithstanding that its equitable foundation is at best unstable and at worst nonexistent, the cap on the allowability of real property lessors’ lost profit claims endured unchanged for the next 35 years. As part of the 1978 Bankruptcy Reform Act, Congress deleted the two maximum caps in favor of the sliding scale discussed in Part II.<sup>234</sup> Congress also for the first time subjected the lost profit claims of employees against their debtor/employers to partial disallowance. Section 502(b)(7) disallows an employee’s claim for damages resulting from the termination of an employment contract to the extent such claim exceeds one year’s worth of salary following the earlier of the filing of the petition or termination of the contract.<sup>235</sup> The legislative history for this section is virtually nil.<sup>236</sup>

#### IV. AN ARGUMENT AGAINST DISALLOWANCE OF LESSORS’ LOST PROFIT CLAIMS

Congress has explained the cap on lessors’ damages claims as necessary to achieve equitable distribution of assets. The cap “is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long term lease) as to prevent other general unsecured creditors from recovering a dividend

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233. *Id.* at 922. Notwithstanding *Oldden*, some bankruptcy courts have declined to read Section 502(b)(6) expressly as an anti-lessor statute. *See, e.g.*, *In re All For A Dollar, Inc.*, 191 B.R. 262, 263 (Bankr. D. Mass. 1996) (declining to deduct post-petition, pre-rejection rent from lessors’ capped claim); *In re Goldblatt Bros. Inc.* 66 B.R. 337, 347 (Bankr. N.D. Ill. 1986) (same). *Contra In re Stewart’s Properties, Inc.*, 41 B.R. 353, 355 (Bankr. D. Haw. 1984), *In re First Alliance Corp.*, 126 B.R. 589, 591 (Bankr. S.D. Cal. 1991). The Ninth Circuit Bankruptcy Appellate Panel probably overruled both *In re Stewart’s Properties, Inc.* and *In re First Alliance* in *In re First Alliance Corp.*, 140 B.R. 531, 533 (B.A.P. 9th Cir. 1992).

234. *See supra* note 14.

235. 11 U.S.C. § 502(b)(7) (1994).

236. The Senate report states: “[Section 502(b)(8)] tracks the landlord limitations on damages . . . resulting from breach of an employment contract, but limits the recovery to the compensation reserved under an employment contract for the year following the earlier of the date of the petition and the termination of employment.” S. Rep. No. 95-989 (1978).

from the estate."<sup>237</sup> But the intrinsic equity of limiting one claimant's recovery so as to supplement another's is not obvious.

In *Oldden*, the Second Circuit noted that real property lessors' claims are different than other creditors' claims in two ways. First, real property lessors get the leased property back, whereas non-lessor creditors have no such claim against property of the estate. Second, the lease, once rejected, is of no benefit to the estate.<sup>238</sup> Both characteristics of real property lessors' claims are true of all claims for lost expectation. Neither observation justifies the policy of sacrificing real property lessors' lost expectation claims to subsidize the claims of other creditors.

A real property lessor who recovers some of his loss by reentering the leased premises asserts a claim exclusively for lost expectation against the estate. The distinction between the claims of real property lessors and other creditors is analogous (arguably identical) to the distinction between the claims of secured and unsecured creditors. By physically recovering the leased premises, the lessor recaptures in part the current market value of his performance. His remaining rights against the tenant are for lost profit on the contract. Other creditors who have no right of recourse against specific property of the estate assert claims to recover the value of their performance *plus* to obtain lost expectation. Because they did not bargain for recourse against specific property, these other creditors start farther back in bankruptcy. It does not follow from this distinction that a lessor's claim for lost profit is less worthy than the contractual claims of other creditors.

The second distinction, that the unexpired lease term does not benefit the estate, does not distinguish real property lessors from other creditors whose claims are based on rejected executory contracts. All creditors whose claims arise from rejection are entitled to treat their own executory obligation to perform under the rejected contract as discharged and recover lost profit by asserting a claim against the estate. In all such cases, the performance the creditor will never render is of no use to the estate. But, the value of such performance is not irrelevant. The creditor's claim against the estate is equal to the creditor's lost revenue less the value of such performance.

In the case of a real property lease, the value of the lessor's performance for purposes of calculating damages on rejection of the lease is equal to the actual or estimated present market value of the leased premises. The same kind of valuation obtains for all rejected contracts. Suppose the debtor had contracted for the delivery of widgets prior to bankruptcy. The trustee then rejected the widget contract. The seller who never delivered the widgets would be entitled to a lost profit claim against the estate measured as the difference between the contract price and the market value of the widgets which by virtue of the rejection the seller never had to deliver. The seller would obtain a claim against the estate for his lost profit even though the estate does not obtain the use of the widgets.<sup>239</sup>

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237. H.R. Rep. No. 95-595 at 354 (1977), *reprinted in*, 1977 U.S.C.C.A.N. 6309.

238. See *Oldden*, 143 F.2d 916, 920, and *supra* discussion in note 229 and accompanying text.

239. The same result would obtain if the seller had delivered the widgets prior to bankruptcy.

The Second Circuit's observations about lessors' claims reveals a bias against claims for lost expectation in favor of claims which combine lost expectation with compensation for reliance interest. This bias derives from the sentiment that property value ought to be derived from its use, not its exchange.<sup>240</sup> The bias, while perhaps perceived as axiomatically equitable during the nineteenth century, is out of step with both contract and bankruptcy theory in the twentieth century.

A clue to the purpose of Section 502(b)(6) might be in the way Congress limited its application. Only "true" lessors' claims are subject to disallowance under Section 502.<sup>241</sup> This suggests that something about the relationship between a true lessor and a debtor/tenant justifies disparate treatment for such lessor's claims relative to claims of the tenant's other creditors. A real property lessor can assert that its relationship with the debtor/tenant is not a "lease" but rather a financing lease, a management contract,<sup>242</sup> a storage contract,<sup>243</sup> or something else.<sup>244</sup> If successful in recharacterizing his relationship, the lessor can escape the limitation of Section 502(b)(6) because his claim against the debtor is not technically "of a lessor." Nor does it "result from the termination of a lease of real property."<sup>245</sup> Once freed from Section 502(b)(6), the court will allow the creditor's claim in full unless another ground for disallowance under Section 502 applies, or the trustee avoids or subordinates his claim under another Bankruptcy Code provision.

The quality of a "true" lease relationship that might justify treating claims for breach of it differently than other claims is as elusive as the distinction between "true" and other leases in the first place.<sup>246</sup> Parties structure their relationships as "leases" to obtain favorable tax treatment or for other reasons, while their credit relationships are the functional equivalent of secured financing transactions.<sup>247</sup>

subject to a purchase money security interest in them. The contract of sale would not be executory and would not be governed by Bankruptcy Code section 365. If the seller successfully obtained relief from the automatic stay to recover the widgets, the seller's claim against the estate for the deficiency would be for lost profit on the contract.

240. See Richard C. Sauer, *Bankruptcy Law and the Maturing of American Capitalism*, 55 Ohio St. L.J. 291, 293, 330-38 (1994). The author chronicles the conflict between republican theorists and merchantilists in the development of American bankruptcy law which culminated with victory for the merchantilists in the Bankruptcy Act of 1898.

241. See S. Rep. No. 95-989, 95th Cong. 2d Sess. 64 (1978). See also *In re PCH Assocs.*, 949 F.2d 585 (2d Cir. 1991) ("lease of real property" refers only to true leases).

242. *E.g.*, *In re Dunes Hotel Assoc.*, 194 B.R. 967 (Bankr. D.S.C. 1995).

243. *In re Dant & Dant*, 39 F. Supp. 753 (W.D. Ky. 1941), *aff'd sub nom*, *Kessler v. Jefferson Storage Corp.*, 125 F.2d 108 (6th Cir. 1942).

244. *In re PCH Assocs.*, 949 F.2d 585 (2d Cir. 1991); *In re Harris Pine Mills*, 862 F.2d 217 (9th Cir. 1988) (timber contracts not leases); *In re Morreggia & Sons, Inc.*, 852 F.2d 1179 (9th Cir. 1988) (right to occupy store units not lease).

245. 11 U.S.C. § 502(b)(6) (1994).

246. For a representative discussion of the distinction between true leases and secured transactions or sales of personal property see, Robert Strauss & Jeffrey J. Wong, *Commercial Law Aspects of Equipment Leasing*, 727 PLI/Comm. 7 (1995).

247. See, *e.g.*, *In re Kassuba*, 562 F.2d 511 (7th Cir. 1977); *In re Central Foundry Co.*, 48 B.R. 895 (Bankr. N.D. Ala., W.D. 1985). Both a lessor and a secured lender bargain for a right to reenter



Although the distinction between true and financing leases is economically chimerical,<sup>248</sup> it remains a key distinction in bankruptcy. The Code provides no basis for distinguishing for legal purposes contracts that are economically indistinguishable. In the report on Section 502(b)(6), Congress noted that "[w]hether a 'lease' is true or bona fide lease or, in the alternative, a financing 'lease' or a lease intended as security, depends upon the circumstances of each case."<sup>249</sup> It cited two specific circumstances which indicate a transaction is not a true lease: 1) the lessee obtains the property at the expiration of the lease for no or nominal consideration; and 2) the lessee assumes "substantially all the risks and obligations ordinarily attributed to the outright ownership of the property."<sup>250</sup>

The first characteristic of a true lease, then, is the allocation to the lessor of the post-performance value of the property to the lessor by agreement of the parties. Put another way, "true" lessors, unlike other creditors with recourse to property upon default, *expect* to "own" the subject property upon the natural expiration of the term of the credit relationship.<sup>251</sup> Distinguishing "true" leases based on which party expects to own the residual value of the property at the end of the term does not explain why a true lessor's claim for breach should be subject to disallowance while a financing lessor's claim is not. The measure of damages for breach of "true" and other leases is the same—the present value of the difference between the lessor's expected revenue from performance of the lease and the value of the property upon reentry (or repossession). Which party expects *ex ante* to own the residual interest in the property at the natural expiration of the lease or loan absent a breach has no effect on the nonbreaching party's damages claim.

The other characteristic of a "true" lease Congress identified—retention by the lessor of "substantially all the risks and obligations ordinarily attributed to the outright ownership of the property"—is also a non-starter. First, given the opportunity to bargain, parties can and do allocate risks to suit their purposes, with the effect that "ordinary" allocations of risk have become indiscernible. When the benchmark allocation of risk disappears, evaluation of a particular relationship against such a nonexistent standard becomes an empty exercise.

In any event, the true/financing lease distinction does not explain the application of Section 502(b)(6) to only true *real property* lessors, as opposed to true lessors of all property, real or personal. The justification for this limitation, if one exists, must derive from a distinction between real and personal property.

(foreclose) on the subject property upon default. And both bargain for the right of recourse against the tenant (borrower) to the extent of any deficiency.

248. Whether a relationship is an assumable lease or a finance contract, according to some courts, depends on which characterization is better for the estate. See *In re Martin Bros. Toolmakers, Inc.*, 796 F.2d 1435, 1439 (11th Cir. 1986); *In re Becknell & Crace Coal Co., Inc.*, 761 F.2d 319, 322 (6th Cir. 1985).

249. Notes of Committee on the Judiciary, Sen. Rep. No. 95-598 (1978), *reprinted in*, 1978 U.S.C.A.N. 5787, 5850.

250. *Id.*

251. The Senate Report states: "[I]n a true lease of real property, the lessor retains all risk and benefits as to the value of the real estate at the termination of the lease." *Id.*

The legislative report notes that historically, real property lessors' lost profit claims were nonprovable, in part because such claims were "considered contingent and difficult to prove."<sup>252</sup> Reliance on historical treatment of real property lessors' claims to justify present treatment, notwithstanding changes in both state and federal law, is unsatisfactory. At the turn of the twentieth century, real property lessors' rent-based claims were non-provable in bankruptcy cases on grounds that absent a contract term to the contrary, a lessor's claim for rent could not be accelerated. During this period, parties increasingly relied on indemnity covenants to protect the lessor's expectation of profit under a lease. Roughly contemporaneous with the enactment of the predecessor to 502(b)(6) in 1934, a lessor proved a claim for damages notwithstanding prior limitations of the common law and difficulty of calculation.<sup>253</sup> Thus, over forty years before Congress enacted Section 502(b)(6) as part of the 1978 Bankruptcy Code, the Court had discredited entirely any contention that lessors' lost profit claims were historically *sui generis* and deserving of disparate treatment.

True, difficulty of liquidation of lessors' claims played an important role in judicial attitudes about the provability of such claims. During the early twentieth century, courts liquidated anticipatory damages notwithstanding a variety of contingencies across the spectrum of property rights.<sup>254</sup> But, in cases involving breach of real property leases, the doctrine of anticipatory repudiation was slow to arrive.<sup>255</sup> And when it did, courts sometimes treated the task of valuing a leasehold interest in real property which extended for years into an uncertain economic future as insurmountable.<sup>256</sup> After *Chicago Auditorium*, however, it became difficult to justify disparate treatment for lessors' anticipatory lost profit claims on grounds of difficulty of liquidation. Lessors' lost profit, particularly under an indemnity covenant which stipulated the measure of damages, was no more difficult to liquidate than lost profit under the contract for livery services at issue in that case.<sup>257</sup> Problems of liquidation turn on uncertainty regarding values into the future, a phenomenon that pervades all executory contractual relationships, not just real property leases.

The cost of liquidating real property lessor's lost profit claims may differ from the cost of liquidating other claims for anticipatory relief if the cost of valuing real property interests are greater than the costs of valuing non-real property interests. The conclusion that land is "unique" so that specific performance is presumptively available as a remedy for breach of performance involving an interest in real property may reflect consensus that real property interests are more costly to value than other interests. If real property lessors' lost profit claims raise peculiar

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252. *Id.*

253. See *supra* note 170 and accompanying text.

254. See discussion of *Chicago Auditorium*, *supra* note 128 and accompanying text.

255. See *In re Roth & Appel*, and discussion *supra* notes 98-113 and accompanying text.

256. See, e.g., *supra* note 177.

257. All contingent or unliquidated claims are costly to estimate. See generally Jackson, *supra* note 4, at 44.

problems of liquidation, however, Section 502(b)(6) does not solve them. It does not eliminate the need to liquidate lessors' lost profit claims under state law.<sup>258</sup>

Section 502(b)(6) may, however, reduce the cost of liquidating real property lessors' claims.<sup>259</sup> Parties will bear the cost of liquidating a lessor's lost profit claim only when the amount of such claim is relatively close to the maximum allowed claim under Section 502(b)(6). Conversely, when all parties concede that the lessor's state law claim exceeds the statutory cap, they will not undertake the cost of precise valuation of the lessor's state law claim.

The administrative appeal of capping claims to reduce liquidation costs is clear. Yet capped claims are the exception not the rule in bankruptcy. The reason for restraint in the use of caps may be the cost associated with the risk that a cap is too low relative to the optimal claim size. If the error cost exceeds the administrative benefit (cost saving) of capping a bankruptcy claim, then the cap is not justified on cost reduction grounds.

Professor Thomas Jackson and others contend that the optimal size of a creditor's bankruptcy claim should equal the creditor's rights against the debtor outside of bankruptcy except when alteration of such rights maximizes collective value.<sup>260</sup> Jackson describes the risk of error associated with rules that alter nonbankruptcy entitlements. Disregard of creditors' nonbankruptcy entitlements other than to maximize value for all claimants "creates incentives for particular holders of rights in assets to resort to bankruptcy in order to gain for themselves the advantages of that rule change, even though a bankruptcy proceeding would not be in the collective interest of the investor group."<sup>261</sup> Even if real property interests raise peculiar valuation problems, the appropriate corrective ought to be the province of nonbankruptcy law.<sup>262</sup>

258. The lessor must still establish extent of his lost profit under the lease and applicable state law. *E.g.*, *In re Financial News Network, Inc.*, 149 B.R. 348, 350-53 (Bankr. S.D. N.Y. 1993); *In re Bob's Sea Ray Boats, Inc.*, 143 B.R. 229, 231 (Bankr. D.N.D. 1992); *In re Atlantic Container Corp.*, 133 B.R. 980, 989-90 (Bankr. N.D. Ill. 1991); *In re Conston Corp.*, 130 B.R. 449, 451-54 (Bankr. E.D. Pa. 1991); *In re McLean Enter., Inc.*, 105 B.R. 928, 937 (Bankr. W. D. Mo. 1989), *contra*, *In re Stewart's Properties, Inc.*, 41 B.R. 353, 355 (Bankr. D. Haw. 1984).

259. *See, e.g.*, *In re All For A Dollar, Inc.*, 191 B.R. 262, 264 (Bankr. D. Mass. 1996) (The cap "sacrificed the precise calculation of contingent future rentals in favor of the benefits of a quickly calculable estimated claim.").

260. Jackson, *supra* note 4, at 28-33.

261. Jackson, *supra* note 4, at 33. *See also* Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 Minn. L. Rev. 521, 532-52 (1981); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 312-15 (1976). Jackson gives the treatment of lessors' lost profit claims under Section 502(b)(6) as an example of a bankruptcy rule that alters nonbankruptcy entitlements without perceptible gains in social wealth. He calls the stated justifications for the cap unsatisfying on their own terms. Jackson, *supra* note 4, at 57.

262. *See* Jackson, *supra* note 4, at 57 (arguing that bankruptcy law ought not correct for problems of liquidation).

[E]ven though a state law (assuming it existed) that generally treated landlords relatively better than other claimants might be an inappropriate nonbankruptcy policy, recognition of that differential treatment nonetheless remains appropriate bankruptcy policy. . . . Casting

Whatever peculiar problems of valuation might arise in the context of long term leases of real estate, bankruptcy courts are perfectly capable of estimating damages from breach of long term leases. If the trustee or debtor in possession assumes the lease, but later breaches it, the lessor is entitled to an administrative claim for his full damages as estimated by the bankruptcy court, unaffected by Section 502(b)(6).<sup>263</sup>

Even assuming difficulty of liquidation is more pronounced with lessors' lost profit claims than other breach of contract claims generally, Section 502(b)(6) is overbroad. Congress did not limit Section 502(b)(6) to apply only to lessors' lost profit claims that are unliquidated. Section 502(b)(6)(A) caps all claims that "result[] from the termination of a lease of real property." Courts have held that it applies even if the lessor's claim is reduced to judgment as of the time of the bankruptcy filing.<sup>264</sup> Disallowance of part of a state court judgment by a bankruptcy court raises a concern that the bankruptcy court is not affording the judgment the required "full faith and credit."<sup>265</sup> Bankruptcy courts reason that Section 502 governs claim allowance, a bankruptcy concept. Since the nonbankruptcy court rendering the judgment could not have considered the allowability of the lessors' claim in bankruptcy, disallowance of part of the lessor's claim under Section 502(b)(6) does not deny full faith and credit to the judgment.<sup>266</sup>

Application of Section 502(b)(6) to disallow part of a lessor's claim which has been reduced to judgment prior to the filing of the bankruptcy case flies in the face of both the historically derived rationale for disparate treatment of lessors' claims and the justification based in difficulty of liquidation. A judgment entered in favor of a lessor pre-petition is not contingent or speculative as of the filing of the bankruptcy case. Such a claim would have been entirely provable under Section

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the issue as one of bankruptcy policy misstates what is at issue and creates incentives to use bankruptcy for reasons that may not be collectively optimal.

*Id.*

263. *E.g.*, *Nostas Assocs. v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996).

264. *E.g.*, *In re Comstock Fin. Servs., Inc.* 111 B.R. 849, 859 (Bankr. C.D. Cal. 1990) (for claim allowance purposes, bankruptcy court is not bound by prior state court judgment except with regard to state court determination of the nature of the claim and amount of damages under state law); *Kohn v. Leavitt-Berner Tanning Corp.*, 157 B.R. 523, 526-27 (N.D.N.Y. 1993) (bankruptcy court honors state court judgment as to the character and amount of lessor's damages, then applies Section 502(b)(6)(A) to disallow such claim notwithstanding judgment).

265. *See* 28 U.S.C. § 1738 (1994); Charles A. Wright et al., *Federal Practice and Procedure: Jurisdiction* § 4469 (1981 & Supp. 1999); *Marrese v. American Academy of Ortho. Surgeons*, 470 U.S. 373, 380 (1985).

266. *E.g.*, *Cutler v. Lindsey (In re Lindsey)*, 199 B.R. 580 (E.D. Va. 1996), *aff'd in unpublished opinion*, No. 96-2268 1997 WL 705435 (4th Cir. Nov. 7, 1997); *Kohn v. Leavitt-Berner Tanning Corp.*, 157 B.R. 523 (N.D. N.Y. 1993); *In re Thompson*, 116 B.R. 610 (Bankr. S.D. Ohio 1990); *In re Comstock Fin. Serv., Inc.*, 111 B.R. 849 (Bankr. C.D. Cal. 1990); *In re Bus Stop, Inc.*, 3 B.R. 26 (Bankr. S.D. Fla. 1980). The bankruptcy court may look behind the judgment to determine the true nature of the claim. *E.g.*, *Boynton v. Ball*, 121 U.S. 457, 7 S. Ct. 576 (1887); *In re Bus Stop, Inc.* 3 B.R. 26 (Bankr. S.D. Fla. 1980); *Cutler v. Lindsey (In re Lindsey)*, 199 B.R. 580, 583 (E.D. Va. 1996); *Kohn v. Leavitt-Berner Tanning Corp.*, 157 B.R. 523, 526 (N.D. N.Y. 1993).

63a(1) of the Bankruptcy Act as a debt "absolutely owing."<sup>267</sup> This application of Section 502(b)(6) starkly illustrates its effect as an incentive for strategic behavior. A tenant faced with a lessor's perfectly valid state court judgment for lost profit can flee to bankruptcy and escape part of it. In this setting, the only effect of disallowance is to enrich the debtor and his non-lessor creditors at the lessor's expense simply because the debtor sought refuge in a federal bankruptcy proceeding.

The sacrifice of lessors' claims for damages in bankruptcy may really be based on intuition that such claims tend to be overcompensatory. The tacit sentiment is that lessors under rejected leases get the leased premises back from the estate, and they should be happy with that. This intuition appeared prominently in *Kuehner*, in which the Court upheld the constitutionality of the precursor to Section 502(b)(6).<sup>268</sup> The Court observed that lessors' claims could rationally (and thus constitutionally) be disallowed in bankruptcy because lessors received a remedy in bankruptcy that other unsecured creditors did not—lessors got their property back from the debtor.<sup>269</sup> Thus, lessors did not truly need full recognition in bankruptcy of their damages claims, while other creditors did.

Of course, lessors whose rights are disallowed bargained for *both* a claim against the tenant/debtor and recourse against the property. A bankruptcy rule that disregards this contractual allocation creates a disincentive on the parties to real property leases to allocate risk of loss this way. Lawyers drafting real property leases no doubt prefer simply to allocate risk among lessor and tenant in other ways rather than challenging Section 502(b)(6) as an unconstitutionally irrational abridgement of due process. During periods of general economic stability, rental values will correspond closely with market values. Under these conditions, a lessor's lost profit claim from her tenant's anticipatory breach of lease is likely to be relatively small. So, during these periods, it is not surprising that Section 502(b)(6) causes little stir. Of course, tenants occasionally make very bad lease deals in good times, potentially yielding a large lost profit claim for a lessor. In many of these cases, given the likelihood of a small dividend to unsecured creditors, the stakes are often too low for serious litigation over the effect of Section 502(b)(6) on claim disallowance. The effect is to force lessors and their tenants to adopt alternative, and less efficient allocative devices.

Suspicion that lessors' damages claims as measured under state law are overcompensatory reflects a fundamental misunderstanding of the nature of lessors' claims. Recall early in the twentieth century courts commonly limited a lessor's right to recover lost profit as exclusively derivative of the lessor's right to rent.<sup>270</sup> But a lessor's damages will be less than lost rent revenue as long as the lessor can

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267. Bankruptcy Act of 1898 § 63a(1).

268. See *supra* note 207 and accompanying text. See also *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1944) (landlord is not in same position as other creditors: "he regains his original assets upon bankruptcy, and the unexpired term in no way really benefits the assets of the bankrupt's estate.").

269. *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 455, 57 S. Ct. 298, 303 (1937).

270. See *supra* discussion note 45 and accompanying text.

recover some revenue by reletting or otherwise exploiting the premises. Put another way, rent will always overstate the lessor's damages when the value of the leased premises is positive.

The intuition that lessors' damages claims were systematically over-compensatory never had any observable basis. In a competitive commercial setting, absent fraud or collusion, a lessor cannot extract a supercompensatory remedy from a lessee, at least not without substantial rent concessions. In the unusual case in which a lease contains a supercompensatory penalty damages provision, the lessor's claim would be disallowed under Bankruptcy Code section 502(b)(1) to the extent it would not be enforceable (as a penalty) under state law.<sup>271</sup>

Certainly, when a lessors' claim for damages from breach of lease has been reduced to judgment outside of bankruptcy, it ought to follow that absent fraud, collusion or corruption, the judgment reflects the lessor's equitable claim against the estate.<sup>272</sup> In this context, if the lessor's judgment is truly overcompensatory, for example because the lessor obtained it by fraud or collusion, it is likely avoidable under Section 548 governing fraudulently incurred obligations.<sup>273</sup> And, if the lessor obtained the judgment by default at a time when the debtor was insolvent or otherwise lacked incentive to defend its interests, then the judgment would not bar relitigation of the issue of damages before the bankruptcy court.<sup>274</sup>

Perhaps the clearest conflict between the redistributive effect of Section 502(b)(6) and equitable bankruptcy policy occurs when the debtor is solvent. In these cases, disallowance of a portion of the lessor's claim does not make other unsecured creditors better off. They will be paid in full in any event. Rather, disallowance enriches the holders of equity interests at the expense of the lessor. It is one thing to contend that bankruptcy law ought to engage in equitable adjustment of claims among creditors. It is quite another to contend that bankruptcy policy ought to sacrifice the claims of a single type of creditor (real property lessors) to enrich the holders of equity interests.

The effect of Section 502(b)(6) when the debtor is solvent first appeared in *Kuehner*. The Court in that case held that disallowance is absolute, even if it enriches equity claimants.<sup>275</sup> The issue reappeared in *In re Federated Department Stores, Inc.*<sup>276</sup> In that case, a real property lessor objected to the debtor's motion to reject the lease. The lessor argued that the debtor-in-possession was solvent, so that rejection of the lease, coupled with disallowance of the bulk of the lessor's

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271. 11 U.S.C. § 502(b)(1) (1994) (claim disallowed to the extent that it is "unenforceable . . . under any agreement or applicable law. . .").

272. Cf. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757 (1994).

273. 11 U.S.C. § 548(b) (1994).

274. See *Murray v. Day* (In re Day), 4 B.R. 750, 755 n.4 (Bankr. S.D. Ohio 1980) (issue preclusion does not apply to judgments by default). See generally James N. Duca and Cori Ann C. Yokota, *The Role of Res Judicata In Bankruptcy Claim Allowance Proceedings*, 17 U. Haw. L. Rev. 1 (1995) (discussing the effect on res judicata of the debtor's insolvency and concomitant lack of incentive to defend against entry of judgment).

275. *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 450, 57 S. Ct. 298, 299 (1937).

276. 131 B.R. 808 (S.D. Ohio 1991).

claim under Section 502(b)(6) would yield no benefit to creditors but would result in a windfall to equity claimants.<sup>277</sup> The district court upheld the bankruptcy court's denial of the lessor's objection on grounds that rejection is appropriate wherever it benefits the debtor, even if it does not benefit unsecured creditors.<sup>278</sup>

The lessor repeated the same argument another way. It argued that disallowance would be inconsistent with Congress' redistributive purpose because the debtor-in-possession was solvent.<sup>279</sup> The court held that Section 502(b)(6) unambiguously applied in all cases, not just those in which the debtor was insolvent.<sup>280</sup> In any event, the court explained that the enrichment of equity claimants at the expense of a real property lessor was not inconsistent with Congressional intent. "[T]he bankruptcy court's decision serves at least one of the purposes of [Section] 502(b)(6): to limit damages claimed for breach of a long-term commercial lease, which have historically been viewed as contingent and difficult to prove."<sup>281</sup> Like the Second Circuit in *Oldden v. Tonto Realty*,<sup>282</sup> the court in *In re Federated Department Stores* held that Congress' intent for Section 502(b)(6) requires courts to single-mindedly minimize lessors' lost profit claims for no reason other than to reduce the recovery of such lessors in bankruptcy cases.

#### V. CONCLUSION

Disallowance of lessors' claims under Section 502(b)(6) is the product of a fascinating confluence of legal and economic events. By the beginning of the twentieth century, contract theory had expanded to permit a party to recover his lost expectation from a breaching party, without actually tendering his own performance. Parties to real property leases used indemnity clauses to create expressly a lost expectation remedy for lessors. Such a remedy was an innovation in real

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277. *Id.* at 810-11.

278. *Id.* 812-13. The district court noted that the bankruptcy court disputed whether the debtor-in-possession was indeed insolvent. Moreover, the bankruptcy court was concerned about the implication of the lessor's motion, that a court must conduct a solvency analysis in connection with each rejection motion. *Id.* at 813.

279. *Id.* at 816.

280. *Id.* at 816, 817 (citing *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 241, 109 S. Ct. 1026, 1030 (1989)). "There is simply nothing in the plain language of [Section] 502(b)(6) to suggest that a bankruptcy court may depart from the application of the cap on a lessor's claim any time the debtor is solvent or the court otherwise believes the equities of the case might warrant such a departure." *Id.* at 817. The district court noted that in *In re Danrik*, 92 B.R. 964 (Bankr. N.D. Ga. 1988), another court refused to apply Section 502(b)(6) to cap a lessor's claim against a solvent lease guarantor. The court in *In re Federated Department Stores*, distinguished *In re Danrik*, inter alia, because the lessor's claim in that case reflected the market value of the premises for the remaining term, and was "proportional" because 70% of it consisted of out-of-pocket expenses. *Id.* at 817. The lessor's claim in the instant case had no such equitable appeal. "In contrast, in the instant case, it appears that the majority of City Center's \$10 million claim consists of lost rent payments." *Id.* The leased premises at issue was a retail store in a virtually vacant mall in Grand Rapids, Michigan while that region was undisputably "economically depressed." *Id.* at 810.

281. *Id.* at 818 (citing S. Rep. No. 989, 95th Cong., 2d Sess. 2266 (1978)).

282. See *supra* discussion of *Oldden*, note 219 and accompanying text.

property leases, and in the view of some, an affront to the common law wherebefore a lessor had no right to recover lost expectation. During this same period, economic depression made the scope of bankruptcy relief a pressing political issue in the 1930's. Congress' response to political pressure for expanded bankruptcy relief was to sacrifice the nascent and theoretically dubious, yet potentially huge expectation interests of real property lessors. The justification for disallowance of part of lessors' claims under Section 502(b)(6) is entirely unconvincing today. Although Congress has constitutional power to alter state law entitlements via bankruptcy law, Section 502(b)(6) is not a justifiable use of that power and ought to be repealed.



