In re MDC Systems, Inc.: 502(b)(6) "Surrendered" to Common Sense

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Section 502(b)(6) of the Bankruptcy Code caps the amount of a lessor's claim against a debtor-lessee for damages arising from the termination of a real property lease. The statutory cap is calculated according to a formula that considers, among other things, the date on which the lessor "repossessed" or the debtor-lessee "surrendered" the leased property. Because those terms are not defined in the Bankruptcy Code, however, courts disagree as to whether state or federal law should determine their meanings for the purpose of calculating the allowed amount of the lessor's claims.

A Pennsylvania bankruptcy court recently weighed in on this issue in *In re MDC Systems, Inc.*, 488 B.R. 74 (Bankr. E.D. Pa. 2013). The court rejected the majority view, ruling that state-law definitions of "surrender" and "repossession" should not determine the amount of a lessor's claim for future rent under section 502(b)(6).

Statutory Cap on Landlord Claims in Bankruptcy

Section 502(b)(6) provides that, upon the filing of a timely objection, a claim filed in a bankruptcy case shall be disallowed to the extent that:

> if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
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> > (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
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> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates . . . .

Section 502(b)(6) thus imposes a ceiling, or "cap," on the allowed amount of a landlord's claim for damages resulting from the termination of a lease of real property. The purpose of the rent cap is to balance the interests of landlords and other unsecured creditors by allowing a landlord "to receive compensation for losses suffered from a lease termination while not permitting a claim so large as to prevent general unsecured creditors from recovering from the estate." *See Solow v. PPI Enterprises, Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003).

Section 502(b)(6) mandates that a lessor's claim for damages resulting from the termination of a lease must be compared to the sum of two amounts: (i) an amount based on "rent reserved" plus (ii) "unpaid rent." If the claim that otherwise would be allowable under applicable nonbankruptcy law exceeds these two amounts, the allowed claim is reduced accordingly.

The "rent reserved" means the amount of future rent under the lease, calculated from the earlier of the date of filing of the bankruptcy petition or the date on which the lessor "repossessed" or the lessee "surrendered" the leased property (such earlier date being referred to as the "Rent Cap Date"). Once the Rent Cap Date is determined, the rent-reserved component of the cap formula is computed by calculating the greater of: (i) the rent under the lease for one year from the Rent Cap Date; or (ii) 15 percent of the rent under the remaining term of the lease from the Rent Cap Date, but not to exceed three years.

"Unpaid rent" refers to the amount of rent that was due but not paid on the Rent Cap Date. Section 502(b)(6) does not limit claims for unpaid rent.

As noted, "repossessed" and "surrendered" are not defined in the Bankruptcy Code. Most courts, representing the majority view, look to state law for a definition of the terms. Even so, as illustrated by the bankruptcy court's ruling in *MDC Systems*, some state-law definitions arguably run at cross-purposes with the policy underlying section 502(b)(6).

MDC Systems

In 2002, MDC Systems, Inc. ("MDC") entered into a 10-year lease agreement whereby it leased commercial property from Brandywine Operating Partnership, L.P. ("Brandywine"). In 2004 or 2005, MDC allowed a related business entity, MDC Systems Corp. LLC ("LLC"), to take possession of the leased property. However, Brandywine never approved any assignment of the lease to LLC.

In July 2005, Brandywine notified MDC that it was in default for failing to pay rent under the lease and sued MDC in Pennsylvania state court for damages resulting from the breach. In November 2007, the Pennsylvania state court entered a judgment in favor of Brandywine for $1,071,024.53.

Shortly before the judgment was issued, Brandywine initiated an ejectment action in state court against LLC in which it alleged that LLC was an illegal occupant or subtenant of the property. In December 2007, before any judgment was issued in the ejectment action, LLC returned the keys

to Brandywine and vacated the premises. MDC filed a chapter 7 petition in Pennsylvania on July 23, 2008.

Brandywine filed a proof of claim in MDC's chapter 7 case in the amount of $1,071,024.53. One of MDC's unsecured creditors, Graf & Graf, P.C. ("Graf"), objected to the claim, contending that the claim should be disallowed in its entirety or, alternatively, capped at $196,510.32 pursuant to section 502(b)(6) of the Bankruptcy Code. Brandywine conceded that section 502(b)(6) applied, but it argued that the claim should be allowed in the amount of $562,703.72.

The Bankruptcy Court's Ruling

As a threshold issue, the court held that, because a claim objection pursuant to section 502(b)(6) is in the nature of an affirmative defense, Graf bore the burden of proof with respect to all issues under the provision.

The primary driver behind the parties' differing claim calculations was a disagreement as to when the Rent Cap Date should be. Graf argued that the Rent Cap Date should be December 29, 2007, the date on which LLC delivered the keys to Brandywine. Brandywine countered that the Rent Cap Date should be July 23, 2008, the date on which MDC filed its bankruptcy petition. As explained previously, under section 502(b)(6), the Rent Cap Date is the earlier of the date of the filing of the bankruptcy petition or the date of "surrender" or "repossession" of the leased premises. Thus, the specific issue presented was whether a "surrender" or "repossession" of the property occurred on December 29, 2007.

Both Brandywine and Graf assumed that applicable state law should determine whether an act of "surrender" or "repossession" occurred for purposes of section 502(b)(6). Under Pennsylvania law, surrender requires "mutual agreement of the parties." Thus, for a surrender to occur under Pennsylvania law, the landlord must accept the surrender.

The court acknowledged that this assumption was not unreasonable on the basis of the approach adopted by most courts, but it declined to follow the majority view. Instead, the court wrote that "the text, structure and purpose of § 502(b)(6) mandate that the term be given the more ordinary, dictionary-like definition: 'The act of yielding to another's power or control.' " (citing BLACK'S LAW DICTIONARY 1484 (8th ed. 2004)).

In other words, the court held, determining when a surrender occurs under section 502(b)(6) is a matter of federal law, and a surrender occurs when a tenant vacates and the landlord takes possession of the leased premises, regardless of how state law defines "surrender." The court adopted this interpretation primarily on the basis of the reasoning articulated in *In re Main, Inc.*, 1997 WL 626544 (Bankr. E.D. Pa. Oct. 7, 1997), *aff'd*, 226 B.R. 140 (E.D. Pa. 1998), *aff'd in part, rev'd in part on other grounds*, 192 F.3d 88 (3d Cir. 1999), and a law-journal article, Eric D. Winston & Nathan A. Schultz, *Sizing Up the "Cap" Commercial Lease Rejection Claims in Bankruptcy*, 27 CAL. BANKR. J. 209 (2004) ("Winston & Schultz").

In *Main*, the court held that Pennsylvania state law should not be used to determine when a "surrender" or "repossession" occurs under section 502(b)(6):

> Section 502(b)(6) presumes that "rent reserved" exists. Were there no "rent reserved," the landlord would have no claim for rent at all. Therefore, a § 502(b)(6) calculation presumes that the landlord's claim for rent has *not* been eliminated. However, the Pennsylvania law referenced [in the district-court order

> remanding the issue to the bankruptcy court in *Main*] considered the issues of "surrender" and "repossession" solely in the context of whether the tenant's entire liability for rent *was* eliminated.
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> As a result, it appears not only unlikely but impossible that the Pennsylvania state law concept of "surrender" or "repossession" and the [§ 502(b)(6)(A)(ii)] concept of these terms could be identical. Whenever rent is due, . . . [a contrary approach would mean that] there will be no "surrender" or "repossession" to stop the running of the rent due pursuant to § 502(b)(6)(A)(ii). Under this reasoning, the only event which could trigger cessation of "rent reserved" is the filing of a bankruptcy petition, bringing § 502(b)(6)(A)(i) into play. In effect, § 502(b)(6)(A)(ii) would never be applicable.
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> We therefore submit that the only logical reading of § 502(b)(6)(A)(ii) requires a conclusion that an event which is *insufficient* to eliminate the landlord's future rent claim may give rise to a § 502(b)(6)(A)(ii) date. In no sense should the state law determination of whether a "surrender" or "repossession" occurred such as would eliminate any future claim for rent reserved control the § 502(b)(6)(A)(ii) determination.

In Winston & Schultz, the authors similarly argue that state law should not control the meaning of "surrender" and "repossession" for several reasons based on their textual analysis of section 502(b)(6) and related sections of the Bankruptcy Code. First, the language of section 502(b)(6), under which the "lessee surrendered" or the "lessor repossessed," indicates that Congress intended for "future rent" claims to be measured from the surrender date, as determined by the lessee's acts, or the date of repossession, as determined by the lessor's acts. Thus, if Pennsylvania law were applied and required the term "surrender" to encompass the lessor's acceptance, that would be inconsistent with the language of section 502(b)(6) requiring only that the "lessee surrendered."

Second, in Winston & Schultz, the authors argue that because courts apply federal law, rather than state law, when interpreting the term "surrender" in section 365(d)(4) of the Bankruptcy Code, courts should apply federal law when interpreting "surrender" in section 502(b)(6) as well.

Section 365(d)(4) requires a trustee to surrender leased nonresidential real property that is the subject of a rejected lease "immediately" to the lessor. Applying the state-law definition of "surrender"—which typically requires both abandonment and a lessor's acceptance—under section 365(d)(4) would produce absurd results, since a trustee could not comply with section 365(d)(4) if the landlord did not accept the surrender.

In addition, the *MDC Systems* court explained, the use of the dictionary definition of the term "surrender" is "consistent with the purpose of § 502(b)(6), which is to reduce a landlord's claim for the period of time in which a valid state law claim for rent exists, but after the leased premises ceases to provide any benefit to the debtor or the bankruptcy estate."

Applying its chosen meaning of the term, the court held that MDC surrendered the premises to Brandywine on December 29, 2007, when LLC delivered the keys to Brandywine. Therefore, the court concluded, December 29, 2007, was the Rent Cap Date for purposes of determining the rent reserved under the lease.

The court rejected Graf's argument that Brandywine's filing of an ejectment action against the LLC in December 2007 terminated the lease under Pennsylvania law and eliminated MDC's obligation to pay any ongoing, future rent such that there was no "rent reserved" for purposes of section 502(b)(6). According to the court, even if the filing of an ejectment action against a *tenant* terminates a lease under Pennsylvania law, an attempt to eject an unapproved third-party occupant of property does not affect the ongoing viability of the lease.

The bankruptcy court denied Brandywine's bid to include as part of its allowed claim the costs it incurred to relet the premises, less the rent it received from the new occupants following the Rent Cap Date. According to this approach, "any mitigation of damages secured by reletting the premises will offset only the landlord's overall potential recovery, and does not affect the § 502(b)(6) cap." However, the court held that the attorneys' fees and costs included in Brandywine's state-court judgment against MDC were not subject to the cap of section 502(b)(6) and would be allowed in their entirety because the attorneys' fees and costs are not "rent."

Factoring all of these adjustments into the calculation of Brandywine's claim (as capped by section 502(b)(6)), the court ruled that Brandywine had an allowed claim in the amount of $400,171.94.

Outlook

The court's ruling in *MDC Systems* would appear to be unusual in the sense that applicable nonbankruptcy law ordinarily determines the amount of a claim. In general, property interests are created and defined by state law. *See Butner v. United States*, 440 U.S. 48 (1979). However, certain provisions of the Bankruptcy Code were expressly designed as a matter of policy to limit claims otherwise allowable under state law. Section 502(b)(6) is one such provision. As *MDC Systems* demonstrates, if applying a particular state law would frustrate the purpose of section 502(b)(6) or render a portion of it superfluous, the courts will likely find a way to rule in a manner such that the language and intent of the Bankruptcy Code are respected to the greatest extent possible.