IT IS ORDERED as set forth below:

Date: February 27, 2015

Mary Grace Diehl

Mary Grace Diehl
U.S. Bankruptcy Court Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

In re:	Case Number:
THE S&Q SHACK, LLC,	09-67151-MGD
Involuntary Debtor.	CHAPTER 7
In re:	Case Number:
RAVING BRANDS, INC.,	09-68410-MGD
Involuntary Debtor.	CHAPTER 7
DARYL DOLLINGER and H. MARTIN SPROCK, Movants,	
v.	**CONTESTED MATTER**
BV RETAIL, LLC, Respondent.	

ORDER PARTIALLY DISALLOWING BV RETAIL, LLC'S CLAIMS AND NOTICE OF STATUS CONFERENCE

By prior order, this court determined that BV Retail, LLC, a Delaware LLC ("BV

Retail"), holds valid claims against the above-named involuntary Debtors, and overruled, in part, the objections made by Daryl Dollinger and H. Martin Sprock ("Objectors"). (Case No. 09-67151, Docket No. 159). The remaining issues relate to the amount of BV Retail's claims. This Order resolves BV Retail's state law contractual damages and the applicable calculation under section 502(b)(6) of the Bankruptcy Code, including which components of BV Retail's claims qualify as "rent reserved" or "unpaid rent" under the statute. This Order also directs the parties to calculate BV Retail's claims based upon this ruling and determine whether further proceedings are necessary to resolve the objections.

The Court has subject matter jurisdiction over this contested matter pursuant to 28 U.S.C. §§ 157 & 1334. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (B), & (O).

I. Relevant Factual Background

As more fully described in the prior order, BV Retail entered into a series of transactions with Debtors in January of 2007. An Assignment, Assumption and Amendment of Lease Agreement ("Lease Assignment") was executed by BV Retail, successor to Ballantyne Village, LLC, and Doc Greene's, Raving Brands, Inc., and The S&Q Shack, LLC. (Exhibit 8 ("Lease Assignment")). S&Q Shack was assigned all rights and obligations under the Lease with a 10-year renewable term beginning on November 1, 2006 (Lease Assignment, ¶¶ 7, 10, Lease Rider). Raving Brands executed a Guaranty, which guaranteed all obligations of S&Q Shack under the Lease. (Exhibits 8 & 9). Raving Brands also executed a Promissory Note, for $57,804.88, with an interest rate of 8% compounded monthly, in favor of BV Retail, to account for the prior tenant's rent

arrearage.[1] (Lease Assignment, ¶ 11 & Exhibit 10).

The parties agree that S&Q Shack breached the Lease by failing to open a Shane's Rib Shack on or after May 1, 2007. (Lease Assignment, ¶ 12(j)). The Lease provides a $100/day charge for breach of Lease section 12(j). Also, there was a breach based on nonpayment of rent. S&Q Shack paid some, but not all, of the rent due under the Lease. Beginning in April of 2008, S&Q made no further rent payments.

Under the Lease, the rental section contains subsections on percentage rent, common area maintenance charges, taxes, insurance, trash, utilities and service, and a marketing fee. (Exhibit 1 ("Lease"), ¶ 7). The late fee assessment is included in the rental section and provides that "[a]ll amounts due but unpaid after [a certain date] shall be subject to a late charge equal to five percent of the amount due until paid . . . and "any unpaid amounts due shall bear interest . . ." *Id*). The marketing fee subsection states, "Tenant shall pay to Landlord the Marketing Fee with each monthly installment of Fixed Minimum Rent." *Id.*

The relevant provisions pertaining to attorneys' fees include:

- Lease Assignment ¶ 13 amends the Lease provisions ¶¶ 18(c), 52:

> If either party places in the hands of an attorney the enforcement of this Lease, or any part thereof, or the collection of any Rent due or to become due hereunder, or recovery of the possession of the Premises, or files suit upon the same, the nonprevailing (or defaulting) party shall pay the other party's reasonable attorneys' fees, paralegal fees, investigative fees, costs and interest, through all appeals, tribunals, bankruptcy proceedings and collection efforts.

Assignment of Lease, ¶ 13.

1 As explained in the prior order, Doc Green's, the prior tenant, was related to Debtors but was a separate entity.

- Lease ¶ 19, Landlord's Performance for Account of Tenant:

  Any amount paid or expense or liability incurred by Landlord in the performance of such matter [curing default] for the account of Tenant shall be deemed additional Rent . . ."

Lease, ¶ 19.

- The Guaranty:

  The Guarantor hereby covenants and agrees to and with the Landlord ... that the Guarantor will forthwith pay to the Landlord all damages that may arise in consequence of any Default by the Tenant, ... including, without limitation, all court costs and reasonable attorneys' fees incurred by the Landlord and caused by any such Default or by the enforcement of this Guaranty. The Parties agree that reasonable attorneys' fees shall mean fifteen percent (15%) of all amounts owed by Tenant or Guarantor, as the case may be, or such other percentage as shall be allowed by law from time to time.

Guaranty, ¶ 1.

- The Raving Brands Promissory Note:

  Upon default the holder of this Note may employ an attorney to enforce the Noteholder's rights and remedies and the maker, principal, surety, guarantor and endorsers of this Note hereby agree to pay to the holder reasonable attorneys' fees not exceeding a sum equal to fifteen percent (15%) of the outstanding balance owing on said Note, plus all other reasonable expenses incurred by the Noteholder in exercising any of the Holder's rights and remedies upon default.

Note, p. 2.

With respect to BV Retail's claim against Raving Brands, the Guaranty provides that Raving Brands "jointly and severally guarantees to the Landlord . . . full and prompt payment of rent, including but not limited to, the Fixed Minimum Rent, Additional Rent and any and all other sums and charges payable by the Tenant. . . ." (Exhibit 9 ("Guaranty")). Also, under the terms of the Guaranty, the obligations of the Guarantor are not diminished "so long as the Tenant continues to be liable . . ." *Id.*, p.C-1.

Prepetition, BV Retail sued Raving Brands in the District Court for the Western District of North Carolina for breach of contract. (Exhibit 11). A consent judgment was

entered on March 4, 2009 against Raving Brands in the amount of $206,051.50 plus attorneys' fees and costs in the amounts of $8,085 and $350 respectively.

Earlier in 2009, S&Q Shack sold substantially all its assets to a third party for $4.7 million and certain equity securities. The Chapter 7 Trustee recovered some of the equities and sold them back to the buyer. The disposition of the cash proceeds is the subject of other litigation.

On March 19, 2009, BV Retail commenced an involuntary Chapter 7 case against S&Q Shack, and the Order for Relief was entered August 27, 2010. On April, 1, 2009, BV Retail commenced an involuntary Chapter 7 case against Raving Brands, and the Order for Relief was entered August 20, 2010. No motion to assume or reject the Lease Assignment was filed, and by operation of section 365(d)(4) and (g), the Assigned Lease was deemed rejected as of the petition date.[2]

In December of 2009, the parties stipulated that BV Retial terminated the Lease and partially relet the Premises. The parties seem to agree as to the amount of rent BV Retail collected from the new tenant, yet they disagree as to the amount of upfit costs incurred by BV Retail and whether the costs should be setoff against the gross rents received under the partial relet.

In November of 2011, an Order approved BV Retail's administrative expense claim in the S&Q Shack case in the amount of $94,545.68 under sections 503(b)(3)(A) and 503(b)(4) and provided for payment of such claim to BV Retail. (Case No. 09-67151; Docket No. 91). The order approving the allowance and payment of the administrative

2 The parties do not contest that the relevant date under section 502(b)(6) is the petition date.

expense claim was based upon the finding that the amounts were reasonable and necessary based upon the services performed in obtaining the order for relief (and defending on appeal).

A Deed in Lieu of Foreclosure Agreement by and among BV Retail, as borrower, and Wells Fargo Bank, N.A., as lender, regarding the Premises subject to the 2007 Lease Assignment (Exhibit 28) was recorded in November 2012. Also, an Assignment of Leases with BV Retail, as assignor and Bix Ballantyne Villlage, LLC, as assignee, was executed in connection with the Deed in Lieu regarding the Premises. (Exhibit 29).

BV Retail filed proofs of claim on September 29, 2011. Those claims have been updated in preparation for trial. The latest amounts were a $914,602.13 claim against S&Q Shack and a $1,306,624.54 claim against Raving Brands. Objectors assert that the claims to the extent allowed should not exceed $405,000 as to S&Q Shack and $112,600 as to Raving Brands.

II. Legal Standard

Objections to claims are governed by 11 U.S.C. § 502(a) which provides that, "A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, ... objects." If a party objects to a claim, the objecting party carries the burden of going forward with evidence to overcome the prima facie validity and amount of the claim. *Juniper Dev. Group v. Kahn*, 993 F.2d 915, 925 (1st Cir. 1993). If the objecting party produces evidence to refute at least one of the allegations essential to the claim's legal sufficiency, the burden of persuasion shifts back to the claimant. *In re Allegheny Int'l, Inc*., 954 F.2d 167, 173–74 (3d Cir. 1992); *In re Britt*, 199 B.R. 1000, 1008

(Bankr. N.D. Ala. 1996). Although Rule 3001(f) places the burden of going forward on the objecting party, the burden of ultimate persuasion rests with the claimant. *Matter of Fidelity Holding Co., Ltd*., 837 F.2d 696, 698 (5th Cir. 1988).

III. Discussion

This Order does not determine the specific amount of BV Retail's claims. Instead, it provides a ruling as to certain legal issues raised by the objections. BV Retail's claims result from S&Q Shack's breach of the Assigned Lease and later deemed rejection and the related Guaranty, Promissory Note and Consent Judgment with Raving Brands. This Order determines what state law damages BV Retail is entitled to under applicable North Carolina law and the rules for calculation of those damages under section 502(b)(6).

A. State Law Damages: Mitigation and Effect of Conveying Property

The determination of property rights under lease agreements and otherwise is governed by state law and the agreement between the parties. *Butner v. U.S*., 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979). With respect to the BV Retail's claim against S&Q Shack, the Objectors assert that, under North Carolina law, BV Retail's claim should be reduced based upon the November 2012 voluntary conveyance of the Premises.

Both parties cite to the same case for opposite outcomes: *Strader v. Sunstates Corporation*, 500 S.E.2d 752 (N.C. App. 1998). BV Retail asserts that *Strader's* ruling supports its position that its damages claim includes rent obligations through the term of the Lease Assignment, ending in 2017. Objectors rely on *Strader's* reasoning to support their position that BV Retail is not entitled to any rents post-conveyance of the Premises.

The parties agree that S&Q Shack breached the Assigned Lease and that BV Retail

partially relet the space in 2009 and voluntarily conveyed the property back to Wells Fargo in November 2012 through a Deed in Lieu of Foreclosure.

Under North Carolina law, a lease is a contract with both property and contractual rights. *Id*. at 756-57. Property rights provide for the right to receive unpaid rents and the reversionary right in the leasehold. *Id*. at 757. Contract rights include the right to sue for breach of express or implied covenants and the right to sue for consequential damages stemming from breach of the lease. *Id*. Termination of a lease extinguishes all property rights, yet contractual rights remain. *Id*. (citing *Holly Farm Foods v. Kuykendall*, 442 S.E.2d 94, 96 (N.C. App. 1994)).

The facts in *Strader* are unusual and differ from this case. In *Strader*, there was a ground lease and the tenant defaulted by its failure to pay the construction loan which was secured by a first lien on the underlying real estate. *Id.* at 753. The lender then foreclosed, depriving the landlord of his residual interest in the real estate. *Id.* at 757. The landlord sued the tenant for "failing to make rental payments for the remainder of the lease term." *Id.* at 753. The trial court awarded the landlord "the present value of lost income stemming from the breach." *Id.* When the North Carolina Court of Appeals affirmed, it noted that the lease in this case was terminated by foreclosure, and after that date, the tenant could be liable only for contractual damages. The Court of Appeals explained that "the proper amount of damages is the present value of the rent for the remainder of the term and the present value of [lessor's] reversionary interest at the end of the term." *Id.* at 757.

Significantly, in *Strader*, the termination of the lease occurred by the foreclosure

sale, and the transfer of the property by foreclosure resulted directly from tenant's breach of the lease. The court explicitly noted that there was no opportunity for the lessor to mitigate its damages prior to the foreclosure and that the lessor was not obligated under the lease to prevent the foreclosure. *Id.* at 759. The *Strader* court rejected the argument that the lessor's damages should be reduced based upon its failure to prevent the foreclosure. *Id.* (also referring to the terms of the lease, which explicitly stated that lessor was not required to make financing payments with a breach).

In *Strader*, the measure of contractual damages equated to the loss of lessor's property rights because the foreclosure resulted in a loss of the lessor's ability to collect future rent from any party and a total loss of the property. Unfortunately for BV Retail, *Strader*, does not stand for the proposition that any foreclosure results in the continued right to rental payments through the lease term.

Here, the parties agree that following S&Q Shack's breach, the Assigned Lease was terminated.[3] BV Retail had a duty to (and did) mitigate its damages. The law in North Carolina is that the nonbreaching party to a lease contract has a duty to mitigate his damages upon breach of such contract. *Weinstein v. Griffin*, 84 S.E.2d 549 (N.C. 1954). In a leasing context, the duty to mitigate means that a landlord must use reasonable efforts to relet the premises to a new tenant. *Isbey v. Crews*, 284 S.E. 2d 534, 537 (N.C. App. 1981). The damages usually available to a landlord in a breach of a lease case are "the amount of rent the lessor would have received in rent for the remainder of the term, less the amount received from the new tenant." *Holly Farm Foods v. Kuykendall*, 442 S.E.2d at 96. If the

3 BV Retail does not precisely identify the status of the Assigned Lease in connection with its claims. Whether the Assigned Lease was terminated or the Premises was surrendered postpetition is not material to the above analysis.

landlord mitigates by reletting, his recovery will consist of what he would have received had the lease been performed, less the net value of what he did receive from reletting during the relevant contract period. *Isbey v. Crews*, 284 S.E.2d at 537-38.

The parties disagree as to whether BV Retail is entitled to damages against S&Q Shack after it voluntarily conveyed the Premises in November 2012 through the Deed in Lieu of Foreclosure and related Assignment of Leases and Bill of Sale. Just as the parties agree that the reletting proceeds in 2009 reduced BV Retail's contractual damages claim, BV Retail's voluntary conveyance of the property back to Wells Fargo in November of 2012 has a similar effect of fully mitigating its lost rent damages. Generally, breach of contract damages are awarded to attempt to place the party in the position it would have been if the contract had been performed. *E.g., Perfecting Service Co. v. Prod. Dev. & Sales Co*., 131 S.E.2d 9, 21 (N.C. 1963). Here, the Deed in Lieu of Foreclosure, was a voluntary conveyance of the Premises. While contractually, BV Retail may have retained contractual damages from S&Q's breach and later termination, yet upon conveyance, BV Retail eliminated its claim to rents it would have received (or other contractual losses) based upon S&Q Shack's tenancy. Upon conveyance, BV Retail could no longer perform itself under the Lease, so it cannot seek damages based upon S&Q Shack's failure to perform. Likewise, the related Assignment of Leases transaction, transferred any rights BV Retail may have retained under the Lease.

Significantly, unlike in Strader, BV Retail's voluntary conveyance through the Deed in Lieu of Foreclosure was not related to S&Q Shack's breach. Here, the breach did not cause the foreclosure, like in *Strader.* Instead, BV Retail voluntarily elected to convey the

property back to Wells Fargo several years following the breach. Accordingly, BV Retail has not established a viable legal theory that would allow it to assert any tenancy with S&Q Shack or entitle it to collect rent or assert consequential damages relating to a property it no longer has any rights to.

In *In re FLYi, Inc.*, 377 B.R. 140 (Bankr. D. Del. 2007), the Bankruptcy Court for the District of Delaware sustained an objection by the liquidating trust to the lessor's claim for unpaid rent. The issue presented to the court in *FLYi* was whether a postpetition sale of the property was lessor's acceptance of surrender of the lease and, accordingly, cut off lessor's claim for future rent. In *FLYi*, the Chapter 11 petition was filed in November of 2005. *Id.* at 141. The lease was rejected in April of 2006 and the lessor sold the property subject to the rejected lease in November of 2006. *Id.* Although the *FLYi* court was confronted with the issue of whether the property subject to the lease had been surrendered under Virginia law, the same general common law principals are applicable here.

The *FLYi* court discredited the reasoning in *In re Ames Dept. Stores, Inc.*, 173 B.R. 80, 82 (Bankr. S.D.N.Y. 1994) and explained that "a sale of property by the landlord terminates the landlord's right to collect future rent from the breaching tenant." *Id.* at 143-44. The *FLYi* court explained that because a sale of property "is so inconsistent with the tenant's estate," that a landlord's right to seek unpaid rent is terminated. *Id.* at 144 (citations omitted). In fact, in a subsequent proceeding that related to the lessor's amended claim for contractual damages, the Bankruptcy Court for the District of Delaware maintained that any contractual claim was limited from the lease rejection date to the date the premises

were sold prior to application of the section 502(b)(6) "rent cap." *In re FLYi, Inc.*, 2008 WL 170555, *5 (Bankr. D. Del. Jan. 16, 2008). Neither party presented any unique aspects of North Carolina law relating to the effect of BV Retail's conveyance of the Premises and the Court found none that would alter this analysis. Additionally, the Assignment of Leases executed in connection with the Deed in Lieu of Foreclosure, assigns all of BV Retail's rights and benefits to the assignee.

BV Retail's voluntary surrender of the Premises to Wells Fargo through the Deed in Lieu of Foreclosure is analogous to the voluntary sale in *FYLi*, and factually dissimilar to the breach resulting in the foreclosure and loss of property in *Strader*. Accordingly, BV Retail's is not entitled to a damages claim under the Lease Assignment beyond November 2012. BV Retail's claims are, accordingly, partially disallowed as set forth above.

The Objectors seem to assert a secondary argument that BV Retail is not entitled to any contractual damages following the Lease termination in 2009. BV Retail relies upon *Kotis Properties, Inc. v. Casey's, Inc.*, 645 S.E.2d 752 (N. C. App. 1998) to support its position that termination of the Lease did not eliminate its ability to seek future rent based upon the provisions of the Lease. The Court agrees that to the extent Objectors seek to limit BV Retail's claim to the stipulated December 2009 termination date, such objection fails based upon the law and terms of the Lease. As BV Retail points out, section 18 of the Lease permits lessor to relet the space without termination. Likewise, section 18 limits BV Retail's recovery based on any mitigation of damages, such as the relet rent and the later conveyance of property. As BV Retail concedes, under North Carolina law and the terms of the Lease, its contractual damages claim is reduced by the value it received when

reletting. *See Isbey v. Crews*, 284 S.E.2d at 537-38.

The parties disagree as to whether BV Retail's claim should be reduced by the net amount of the relet, which reduces the rents BV Retail received by the cost of upfitting the new tenant, or whether the gross amount of rents received should be deducted in determining BV Retail's claim. The parties also seem to disagree as to the amount of such upfit costs, which may require the Court to hear evidence. To the extent necessary, this issue will be preserved for further adjudication.

B. Application of Section 502(b)(6)

A landlord's claim for damages is determined by state law and the terms of the lease and then limited by section 502(b)(6). *In re Smith*, 249 B.R. 328 (Bankr. S.D. Ga. 2000). Section 502(b)(6) is not a formula for determining the total allowable damages incurred by a lessor. Rather, this section limits the amount a lessor may recover under the Bankruptcy Code. *In re Allegheny Intern., Inc*., 136 B.R. 396 (Bankr. W.D. Pa. 1991), *aff'd and remanded*, 145 B.R. 823 (W.D. Pa. 1992). The amount of the lessor's claim therefore must be ascertained prior to the application of § 502(b)(6). *In re All for A Dollar, Inc*., 191 B.R. 262, 264–65 (Bankr. Mass. 1996); *In re Thompson*, 116 B.R. 610, 613 (Bankr. S.D. Ohio 1990). Although this order does not determine the precise amount of BV Retail's claims, the ruling above regarding its right to damages until the November 2012 conveyance is relevant to the section 502(b)(6) calculation.

Section 502(b)(6) provides:

> Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such

amount, except to the extent that—

(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).

In addition to the state law damages analysis above, the statutory language of section 502(b)(6) also supports limiting BV Retail's claim to the period prior to conveyance of the Premises through the Deed in Lieu of Foreclosure. Section 502(b)(6) states that it applies to "the claim of a lessor for damages *resulting from the termination* of a lease of real property...." (emphasis added). It is BV Retail's burden to establish that its asserted claims resulted from the termination or, here, deemed rejection of the Assigned Lease.[4] BV Retail's 2012 voluntary conveyance of the property eliminates its ability to establish the necessary causal connection of its lost future rents to the Lease rejection/termination, as required by section 502(b)(6). *See In re Int'l BioChemical Indus., Inc.,* 521 B.R. 395, 401 (Bankr. N.D. Ga. 2014); *In re El Toro Mat. Co.*, 504 F.3d 978, 980-81 (9th Cir. 2007).

BV Retail also seems to assert an equity argument that the facts of this case regarding the prepetition sale and later recovery by the Chapter 7 Trustee should eliminate

4 The parties have not raised any arguments regarding termination, and courts have treated lease rejection as termination under section 502(b)(6). In *In re Emple Knitting Mills, Inc*., 123 B.R. 688, (Bankr. D. Me. 1991), the court stated that while a trustee's rejection of an unexpired lease does not terminate the lease in the sense of destroying or extinguishing the leasehold estate, it serves to limit a lessor's recovery from the bankruptcy estate pursuant to 11 U.S.C.A. § 502(b)(6). *See also In re Rhodes, Inc*., 321 B.R. 80 (Bankr. N.D. Ga. 2005), 2005 WL 4713601 (Bankr. N.D. Ga. 2005), *but see* Michael St. Patrick Baxter, *"The Application of § 502(b)(6) to Nontermination Lease Damages: To Cap or Not to Cap?"* 83 AM. BANKR. L.J. 111, 122–23 (Winter 2009) (asserting that Congress recognizes breach and termination as separate and distinct concepts and that § 365(g) provides that rejection is a breach, not a termination).

the application of the section 502(b)(6) cap. BV Retail argues that Debtors engaged in wrongdoing and, as such, limiting BV Retail's claim under section 502(b)(6) would likely have the effect of shareholders, including Objectors, receiving a distribution. BV Retail's argument is weak especially because it initiated these bankruptcy proceedings and was able to make an assessment whether it wanted to seek relief under the Bankruptcy Code. Additionally, the caselaw providing for landlord claims beyond those allowable by section 502(b)(6) are limited to factual scenarios where landlords assert that their claims do not result from termination of the lease. *E.g., In re El Toro Mat. Co.*, 504 F.3d 978, 980-81 (9th Cir. 2007). This argument does not conform to the law and is without merit.

Section 502(b)(6) applies to BV Retail's claims. The Objectors assert that BV Retail's claim should be disallowed to the extent they fail to conform to statutory allowance under section 502(b)(6). There are several legal issues implicated by the objection relating to the statute. First, the objection contests the inclusion of late fees, interest, attorneys' fees, marketing fees, and failure to open penalties in the prepetition and lease rejection claim. While the prepetition and rejection claim are treated under different subsections of section 502(b)(6), the analysis for whether these amounts constitute rent is identical. Second, the objection asserts that the calculation of lease rejection damages is improper because BV Retail uses a 15% factor against the total amount of rent owing under the Lease ("rent approach"). Objectors argue that the 15% under subsection (A) relates to the number of months remaining on the Lease ("time approach"). Third, the applicability of section 502(b)(6) to BV Retail's claim against Raving Brands as guarantor is addressed. Fourth, whether BV Retail is entitled to an administrative expense claim under section

502(f) claim is determined. Fifth, whether BV Retail's award of attorney fees under section 503(b)(3)(A) and (b)(4) affects the "rent cap" analysis is addressed.

Although the legislative history and statutory purpose are discussed in more detail below, it is instructive to note that "[s]ection 502(b)(6) is designed to compensate a landlord for the loss suffered upon termination of a lease, while not permitting large claims for breaches of long-term leases, which would prevent other general unsecured creditors from recovering from the estate." *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 97 (B.A.P. 9th Cir. 1995). Again, a landlord's claim for damages is determined by state law and then limited by section 502(b)(6).

1. What constitutes "rent reserved" under section 502(b)(6)(A) and "unpaid rent" under section 502(b)(6)(B)?

The Lease at issue is a net lease and includes variable and additional charges designated as rent under its terms. Specifically, BV Retail's claims include amounts that relate to marketing fees, late fees, breach of covenant (failure to open), and interest.[5] BV Retail's claims also include attorneys' fees under several theories. The parties disagree as to the treatment of these amounts and whether they constitute rent.

Under § 502(b)(6)(A), BV Retail may claim damages not to exceed the "rent reserved" under the Lease from the petition date to the date the property was conveyed, without acceleration. This corresponds to the postpetition rejection calculation, which BV Retail refers to as the future rent. Under the next subsection, § 502(b)(6)(B), BV Retail

5 It is unclear whether all of these charges are included in both the prepetition and future rent portions of BV Retails' claims. Since the analysis is the same and this Order does not determine the amount of BV Retail's claims the distinction is immaterial to this ruling.

claims damages corresponding to the prepetition portion of its claim, which includes marketing fees, late fees, breach of covenant (failure to open), and interest. BV Retail also includes attorneys' fees in its claims but the apportionment of such fees is unclear at this time. Attorneys' fees under section 502(b)(6) will also be addressed.

The Objectors urge the Court to apply the test established in *In re McSheridan*, and exclude the additional amounts beyond fixed minimum rent included in BV Retail's claims. Regarding the prepetition charges, BV Retail asserts that if the charges are allowable under North Carolina law and the Lease, then the amounts should not be disallowed, citing *In re Clements* and *In re Q-Masters, Inc.* Alternatively, BV Retail asserts that, even if the *McSheridan* test is applied, the additional amounts satisfy the test.

It seems the primary disagreement between the parties relates to the prepetition rent calculation. Although *McSheridan* was solely concerned with what charges constitute "rent reserved" under section 502(b)(6)(A), numerous courts have extrapolated that analysis to determine what charges constitute "unpaid rent" under section 502(b)(6)(B). *E.g.s*, *In re Foamex Int'l, Inc.,* 368 B.R. 383 (Bankr. D. Del. 2007); *In re Edwards Theatres Circuit, Inc.,* 281 B.R. 675 (Bankr. C.D. Cal. 2002); *In re Smith,* 249 B.R. 328, 337 (Bankr. S.D. Ga. 2000); *In re Blatstein,* 1997 WL 560119, *13 (E.D. Pa. Aug. 26, 1997); *In re Fifth Ave. Jewelers, Inc.,* 203 B.R. 372, 381 (Bankr. W.D. Pa. 1996). Section 502(b)(6)'s statutory language uses the term "unpaid rent" instead of a generic measure of damages. The Court in *In re Edwards Theatres Circuit, Inc.* reasoned that if the statutory purpose is to be achieved, a restrictive view of what constitutes "rent" should apply to both subsection (A) governing postpetition "rent reserved" under a lease and subsection (B) governing unpaid

prepetition rent. *In re Edwards Theatres Circuit, Inc.,* 281 B.R. at 684.

McSheridan establishes a three part-test to determine whether certain items constitute "rent" for purposes of section 502(b)(6). *In re McSheridan,* 184 B.R. at 99-100; *In re Foamex Int'l, Inc.,* 368 B.R. 383 (Bankr. D. Del. 2007) (application to section 502(b)(6)(B)). First, the charge must: (a) be designated as "rent" or "additional rent" in the lease; or (b) be provided as the tenant's/lessee's obligation in the lease. *In re McSheridan,* 184 B.R. at 99-100. Second, the charge must be related to the value of the property or the lease thereon. *Id.* Finally, the charge must be properly classifiable as rent because it is a fixed, regular, or periodic charge. *Id.* The court in *McSheridan* explained that a charge is not exclusively determined to be rent by its label in a lease agreement but, instead, by its substance. *Id.* at 99. In *McSheridan,* the court concluded that the additional charges of building improvement fees, repair and maintenance fees, meal and entertainment fees, remodeling fees, insurance, and taxes, may meet the three-part test and remanded the case to the bankruptcy court to make the determination. *Id.* The Court in *McSheridan* did, however, warn that if every charge in a lease is classified as "rent reserved" it "could conceivably apply to every covenant in the lease and would nullify the provisions of section 502(b)(6)(A), which was meant to cap the damages, not to encourage the allowance of the entire damage claim." *Id.*

BV Retail argues that *McSheridan* should not control. Instead, BV Retail relies upon *In re Clements*, 185 B.R. 895 (Bankr. M.D. Fla. 1995), which allowed all sums under the lease to be allowed subject to section 502(b)(6)'s cap, including attorneys' fees as provided by the guaranty. The *Clements* court explained without much analysis that the guaranty

provided that "expenses incurred by things to be performed thereunder by Lessee. . . ." are included in the lessor's claim. *Id.* at 902-03. The *Clements* court also found it persuasive that the lease specifically made the lessee responsible for paying the taxes, insurance, and maintenance on the property. *Id.* at 902. Yet, in making its ruling, the court did note that the statutory language was limited to rent not damages. *Id.* at 903. The reasoning in *Clements* is not persuasive to this Court.

BV Retail also asserts that the analysis of section 502(b)(6) in *In re Q Masters, Inc.*, 135 B.R. 157 (Bankr. S.D. Fla. 1991) is more applicable than *McSheridan.* In *Q Masters,* the court permitted property damages claim to exist in excess of the capped rent amount under section 502(b)(6) as unrelated to lease termination. The property damage example seems unique and not applicable to these facts. *See also, e.g., In re El Toro Mat. Co., Inc.*, 504 F.3d at 980 (excluding claims for waste, nuisance and trespass from the section 502(b)(6) cap because they did not result from rejection of the lease.).

Section 502(b)(6)(A) encompasses damages to the extent they arise from the termination of the lease. *In re Smith,* 249 B.R. at 336-37; *In re PPI Enters. (U.S.), Inc.,* 228 B.R. 339, 349 *subsequently aff'd*, 324 F.3d 197 (3d Cir. 2003); *In re Fifth Ave. Jewelers, Inc.,* 203 B.R. at 380-81. Here, BV Retail has not established that its claims fall outside of the scope of section 502(b)(6). Accordingly, it is appropriate to assess BV Retail's claims under the *McSheridan* framework to determine whether such amounts can included in the calculation under the statute.

A. Marketing Fees

Objectors contest inclusion of the marketing fee in BV Retail's prepetition claim.

Under the Lease, the marketing fee is designated in the rent section and paid monthly with the fixed minimum rent. The marketing fee is tied to the number of square feet. Under these terms, the marketing fees qualify as unpaid rent (and to the extent applicable "rent reserved") under the *McSheridan* test and can be used in calculating section 502(b)(6)'s "cap."

B. Late Fees and Interest

Objectors also contest the inclusion of late fees and interest in BV Retail's claim. Under the lease, late fees and interest are treated together in the rent section. The Lease provides that "[a]ll amounts due but unpaid after [a certain date] shall be subject to a late charge equal to five percent (5%) of the amount due but unpaid . . . and "any unpaid amounts due shall bear interest . . . ."

Under the requirements of *McSheridan*, the first element is satisfied because these provisions are included in the rent section of the Lease. Yet, the remaining two factors are not met. The late fees and interest do not relate to the value of the property and are not fixed, periodic charges.

The reasoning in *In re Smith* is persuasive to this Court. The Bankruptcy Court in the Southern District of Georgia applied the *McSheridan* three-part test, in *In re Smith* and excluded numerous fees from "unpaid rent" under section 502(b)(6)(B) despite the charges being designated as additional rent under the terms of the lease. *In re Smith,* 249 B.R. at 339-40. Common area maintenance and taxes were allowed, while remaining charges (excused rent, unamortized building allowance, late charges, interest, and attorneys' fees) were excluded from the claim. *Id.*

The *Smith c*ourt explained that late fees are not tied to the value of the property and that they are not due on a regular, periodic or fixed basis; therefore, they do not meet the second and third prongs of the *McSheridan* test. *Id.* Although the Court noted that the late fees were classified as "additional rent" in the lease, it also explained that claims are allowed not according to labels but, instead, according to substance. *Id.* The Court found that late fees are not tied to the value of the property and that they are not due on a regular, periodic, or fixed basis, "but only when a payment is in fact late." *Id.* The court further stated that "[l]ate charges are a penalty for untimely payment. [They are] not rent and not allowed." *Id.* at 340(citing *In re PPI Enters.,* 228 B.R. 339, 349–50 (Bankr. D. Del. 1998) and *In re Fifth Ave. Jewelers,* 203 B.R. at 381).

Furthermore, the *Smith* court found that interest failed all prongs of the *McSheridan* test. *Id.* First, interest was not designated as rent or additional rent in the lease. *Id.* Second, it was not related to the value of the property. *Id.* Finally, "rather than being due regularly, it was only due upon default" and thus is not due on a regular, periodic, or fixed basis. *Id.*

Here, similar to the court's analysis in *Smith*, late fees and interest under the Lease do not meet the second and third requirements under *McSheridan* and are more akin to a penalty than periodic payments related to the value of the property. Accordingly, BV Retail's claims for late fees and interest whether in the form or "rent reserved" or "unpaid rent" are excluded from the section 502(b)(6) calculation.

C. Breach of Covenant: Failure to Open Fee

Objectors also seek to disallow the failure to open penalty components to BV Retail's

claims. BV Retail asserts that it these amounts are allowable damages under North Carolina law. However, in application of the *McSheridan* test, the fee fails all three requirements. This obligation is not designated as rent under the terms of the Lease or the Lease Assignment. Instead, it is set out as a covenant. Additionally, the $100/day charge is not tied to the value of the property; it is better characterized as a penalty. *See In re Smith*, 249 B.R. at 340 (citing *In re PPI Enters.,* 228 B.R. at 349–50 and *In re Fifth Ave. Jewelers,* 203 B.R. at 381).

BV Retail asserts that the daily charge is related to the value of the property because in a shopping center the rate of occupancy affects the value for other tenants. Yet, even if that argument prevails, the daily penalty fails to satisfy the third requirement of periodic payments. As explained in *PPI Enterprises*, the $100/day charge only arises as a result of debtor's default or breach of the covenant. Accordingly, the charges can't be periodic. 228 B.R. at 350 (characterizing the late fees as an incentive to the lessee to make timely payments and not related to the value of the property.). Accordingly, the breach of covenant penalty is excluded from section 502(b)(6)'s calculation.

D. Attorneys' Fees

BV Retail asserts that it is entitled to reasonable attorney fees' under the terms of the Lease, Guaranty and Promissory Note[6] and applicable North Carolina law up to 15% of the outstanding indebtedness for each document. Objectors argue that all of BV Retail's attorneys' fees relate to termination of the Lease, and that the asserted attorneys' fees are not "rent reserved" or "unpaid rent" under section 502(b)(6).

6 As noted previously, this Order does not address attorneys' fees as they may relate to amounts owed by Raving Brands outside the scope of section 502(b)(6).

As with the other charges, it is appropriate to apply the *McSheridan* test to make this determination. 249 B.R. at 339. "[C]ourts have held that the § 502(b)(6) cap "represents that maximum amount recoverable as a result of the termination of the lease, thereby precluding the payment of attorneys' fees as additional damages." *In re PPI Enters. (U.S.)*, Inc., 228 B.R. at 348 (citing *In re Blatstein*, 1997 WL 560119, *16 (E.D.Pa. Aug. 26, 1997); *see also Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 102 (B.A.P. 9th Cir. 1995) (holding that "all damages due to nonperformance [under the lease] are encompassed by [502(b)(6)]").

Attorneys' fees may arguably be referred to as rent under the Lease Assignment at paragraph 13: "any amount paid or expense or liability incurred by Landlord in the performance of such matter [curing default] for the account of Tenant shall be deemed additional Rent . . ." under the Lease section entitled, Landlord's Performance For Account of Tenant. (Lease Assignment, ¶ 13). Even if this provision satisfies the first prong of the *McSheridan* test, the remaining requirements are not met. S&Q Shack's other obligations for attorneys' fees are presented in the default section of the Lease without reference to rent. Second, the attorneys' fees are not tied to the value of the property. *In re PPI Enters.,* 228 B.R. at 348–49 (explaining attorneys' fees are akin to a financial covenant. Lastly, the fees are not incurred on a periodic basis.

To the extent BV Retail seeks to assert attorneys' fees against Raving Brands outside the scope of section 502(b)(6), this issue is preserved and can be addressed at the status conference noticed below. Otherwise, the attorneys' fees under the Lease and Guaranty are excluded from the section 502(b)(6) calculation as "rent reserved" or "unpaid rent."

2. Does the 15% reference in section 502(b)(6)(A) relate to time or rent?

Courts disagree as to whether the "time approach" or the "rent approach" under section 502(b)(6)(A) should be used to calculate the 15 % cap on claims for remaining rent due under a lease. *Compare In re Andover Togs, Inc.,* 231 B.R. 521, 547 (Bankr. S.D.N.Y. 1999) (using 15 percent of the total rents due under the lease to calculate lessor's available claim); *U.S. v. Iron Mountain Mines, Inc.*, 812 F.Supp. 1528, 1557 (E.D. Cal. 1992), *with In re Heller Ehrman, LLP,* 2011 WL 635224 (N.D. Cal. 2011) (finding that "the time approach is consistent with a plain reading of the statute, applicable legislative history, and equitable principles"); *In re Shane Co.* 464 B.R. 32, 39 (Bankr. D. Colo. 2012) (fifteen percent of the remaining term of the lease is plainly a reference to an amount of *time* not money"). The majority of courts have determined that section 502(b)(6)(A) requires the 15% cap to be measured as a function of the remaining amount of rent due under the lease (the "rent approach") and BV Retail advocates for such approach. The Objectors seek application of the statute under the time approach.

Section 502(b)(6)(A) provides:

> Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—
>
> (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 . . .

11 U.S.C. § 502(b)(6). Bankruptcy courts are bound by the plain language of the Code. *U.S. v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242, (1989). A statute that is unambiguous must be

enforced according to its terms unless the result is "demonstrably at odds" with congressional intent. *Id*. The majority of courts take the view that because the statute may be understood by "reasonably well informed persons in two or more different senses" and because there is a circuit split on the issue, the language of the statute is unclear and ambiguous. *In re Andover Togs, Inc.,* 231 B.R. 521, 525 (Bankr. S.D.N.Y. 1999); *U.S. v. Iron Mountain Mines, Inc.*, 812 F.Supp. 1528, 1557 (E.D. Cal. 1992). Because of this discrepancy, courts do not merely rely only on the plain language of the statute; they further consider the legislative history of the statute. Based upon the statutory language, the context of the statute, and the legislative history, this Court adopts the "time approach."

The statutory context includes time periods: "greater of one year" and "not to exceed three years." Accordingly, the "15 percent" is best interpreted as it relates to time remaining under the lease. *In re Elec. Acquisition, LLC,* 342 B.R. 831, 833 (Bankr. M.D. Fla. 2005); *In re Shane Co.* 464 B.R. 32, 39 (Bankr. D. Colo. 2012). The legislative history of the statute reveals that the legislature paraphrased the statute as damages that "are limited to the rent reserved for the greater of one year or ten percent [later increased to fifteen percent] of the remaining lease term, not to exceed three years." H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 353 (1977). The better interpretation of Congress' intent is that Congress intended for the 15% cap to be calculated according to the remaining time under the lease term, not the remaining rent. *n re Iron Oak Supply Corp.,* 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994); *In re Heller Ehrman LLP*, 2011 WL 635224 (N.D. Cal. 2011).

The legislative history of the statute also provides that the purpose of section 502(b)(6)(A) is to ensure that landlords are compensated fairly and to ensure that

landlords' claims do not prevent other unsecured creditors from recovering from the estate. S. REP. NO. 95-989, at 63 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5849). The legislative history gives two reasons for the "need to limit a landlord's claim." First, if the landlord's claim was not limited, other creditors will be prejudiced and will recover a disproportionate amount. *Id.* Second, a landlord's claims are paid up until the date of the petition and a landlord regains possession of the property; thus, the landlord is not in the same position as other creditors. *Id*. These purposes are better fulfilled using the "time approach" because computation of the 15% cap in terms of time would generally allow a smaller, but fair, distribution to landlords while preserving some of the estate to compensate other unsecured creditors. *In re Connectix Corp.*, 372 B.R. 488, 493 (N.D. Cal. 2007).

Furthermore, some courts and commentators have explained that the phrase "without acceleration" in the statute only has meaning when interpreting the 15% cap to be measured as a function of time. The court in *In re Iron Oak Supply Corp.* explained, "[t]he phrase 'without acceleration' only makes sense in terms of a reference to the next succeeding periods under the lease. Taking 15 percent of all the rent for the remaining term, especially where escalation clauses are present, would be tantamount to effecting an acceleration." *In re Iron Oak Supply Corp.,* 169 B.R. 414, 420 (Bankr. E.D. Cal.1994). The Court agrees with the reasoning that had Congress intended the computation of the cap to be based on the remaining rent due, it likely would not have specified that reserved rent must be considered "without acceleration." *See In re Heller Ehrman LLP,* 2011 WL 635224; *In re Allegheny Internat'l, Inc.,*145 B.R. at 827-28; *In re Iron Oak Supply Corp.,* 169

B.R. at 420.

3. Section 502(b)(6) Applies to BV Retail's Claim against Guarantor Raving Brands

BV Retail's claim against Raving Brands seeks non-capped amounts under what is characterizes as an absolute guarantee. The "rent cap" set forth in 11 U.S.C. § 502(b)(6)(A), however, applies to claims against guarantors of leases. *E.g.*, *In re Elec. Acquisition, LLC*, 342 B.R. at 833 ("The limitation set forth in 11 U.S.C. § 502(b)(6)(A) applies to claims against guarantors of leases."); *In re Henderson*, 305 B.R. 581 (Bankr. M.D. Fla. 2003); *In re Clements,* 185 B.R. at 901 ("Although the language of § 502(b)(6) does not expressly mention guarantors, case law has firmly established that it applies to guarantors of leases in bankruptcy, as well as lessees."). The statutory language of section 502(b)(6) does not provide any basis to exclude its application with claims against guarantors.

Additionally, since the obligation of the guarantor cannot be greater than the principal obligor, limiting the claim against the guarantor promotes the same policy rationale that allows for limited compensation to the landlord under a long-term lease without eliminating any recovery for the other general unsecured creditors. *In re Elec. Acquisition, LLC*, 342 B.R. at 833. Should the parties need to present evidence as to the calculations under the Guaranty, this issue can be discussed at the status conference noticed below.

4. BV Retail is Not Entitled to a Section 502(f) Administrative Expense Claim.

BV Retail's claim against S&Q Shack includes a $120,126 portion for postpetition rent under the Lease and section 502(f). This amount is in addition to the future rent BV

Retail calculated under section 502(b)(6). BV Retail initially asserted that this portion of its claim qualified as an administrative expense, but it has since conceded this amount is not an administrative priority claim, and the Court agrees. 11 U.S.C. § 503(b) (excluding claims allowed under section 502(f)).

Sections 502(f) and 507(a)(2) address "gap claims" in involuntary cases where the petition date and the date of the order for relief differ. Section 502(f) governs the allowance of such claims. It provides:

> In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier for the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

11 U.S.C. § 502(f). Section 507(a)(2) affords gap claims priority in payment ahead of other unsecured claims, except administrative claims. BV Retail's section 502(f) claim is limited to the period between the petition and when the premises were relet, instead of the date the order for relief was entered. This Order sustains the objection as to classification of the claim. Any remaining factual issues may be presented at the status conference noticed below.

5. Allowance and Payment of Section 503(b)(3)(A) and (b)(4) attorneys' fees does not affect BV Retail's 502(b)(6) Claim.

Objectors assert that the Court's prior allowance and payment of BV Retail's attorneys' fees under section 503(b)(4) should offset the attorneys' fees in BV Retails' claims. The allowance and payment of the attorneys' fees under the order was based upon the finding that the amounts were reasonable and necessary based upon the services

performed in obtaining the order for relief (and defending on appeal). The application set out the services not relating to BV Retail's work as a petitioning creditor. Objectors have not carried their burden that the allowance of the section 503(b)(3)(A) and (b)(4) claim resulted from termination of the Lease. Otherwise, Objectors do not present a viable legal basis to setoff the allowance of these fees with those pertaining to BV Retail's claim as landlord.

IV. Conclusion

The claims sought by BV Retail are partially disallowed based upon its available state law damages, as limited by the 2012 conveyance of the Premises and the Assignment of Leases, and the application of section 502(b)(6). The amount of BV Retail's claims will be determined by further hearing in a manner consistent with this Order. Accordingly, it is

ORDERED that the Objection by Messrs. Dollinger and Sprock is hereby partially **SUSTAINED** and BV Retail's claims are partially **DISALLOWED**.

It is **FURTHER ORDERED AND NOTICE IS HEREBY GIVEN** that a status conference regarding any remaining issues relating to BV Retail's claims will be held before the undersigned on **April 9, 2015** at **2:00 p.m.**, Room 1201, United States Courthouse, 75 Spring Street, S.W., Atlanta, GA 30303.

The Clerk's Office is directed to serve a copy of this order on the parties and their counsel.

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