8th Circ. Ruling Clarifies Bankruptcy Rent Cap Guidance

By **Brian Shaw** (December 22, 2021, 12:04 PM EST)

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Only a few bankruptcy practitioners are unfamiliar with Section 502(b)(6) of the Bankruptcy Code.[1]

Waves of retail bankruptcies over the past decades have ensured that is the case, and the general application of Section 502(b)(6)'s limitations on the allowance of landlord claims against bankruptcy estates is generally noncontroversial.

Less familiar, particularly within bankruptcy cases, is the effect Section 502(b)(6) has on the balance of the landlord's underlying, substantive state law claim for breach or termination of a lease once it's reduced by application of Section 502(b)(6)'s cap.

Simple questions, such as whether the balance of the state law claim is viable against other entities outside of bankruptcy, or if the landlord is similarly bound outside of bankruptcy by the limitations imposed by Section 502(b)(6), are rarely addressed within the bankruptcy case itself — because the discussion about the landlord's claim in the bankruptcy typically ends after the application of Section 502(b)(6).

Yet, the answers to these important questions, particularly from a circuit court, are very instructive and arm practitioners with information that is necessary to properly advise their debtor/tenant clients.

In Lariat Cos. Inc. v. Wigley,[2] the U.S. Court of Appeals for the Eighth Circuit tackled these important questions in one of those unusual cases that addressed the viability of the balance of a landlord's state law claim after application of Section 502(b)(6) within the context of a bankruptcy case.[3]

The Wigley court, in addition to the questions noted above, faced a rather unusual argument — namely that the application of Section 502(b)(6) and the satisfaction of the landlord's allowed, capped claim by a bankruptcy estate, can serve as a defense to a dischargeability action brought against the debtor under Section 523.[4]

But first, in order to reach its conclusion, and its rejection of an unusual defense, the Eighth Circuit also provided practitioners with a simple, cogent explanation as to the effect of Section 502(b)(6) on the state law claim, generally, and on the continued viability of the balance of the state law claim.[5]

Section 502(b)(6)

Section 502(b)(6), as well as its predecessors under both the Bankruptcy Code and Bankruptcy Act,[6] were crafted to balance the need to compensate landlords for their losses while simultaneously not permitting the same claims from being so large that they prevent other creditors from obtaining meaningful recoveries from a bankruptcy estate.[7]

Section 502(b)(6) achieves this balance by limiting the allowed amount of any such claim to the rent reserved for the greater of one year or 15% of the remaining lease term, not to exceed three years, following the earlier of the petition date or surrender or possession.[8]

By providing claimants, debtors and courts with a bright line — albeit one that still leads to calculation disputes — bankruptcy courts do not have to grapple with, and can discard, claim objections based purely on equitable or other hard-to-pin-down principles.

Rather than guess about when and for how much a landlord may re-lease its premises four years in the future, bankruptcy courts are able to utilize a formula to determine the appropriate amount of a landlord's allowed claim against an estate.[9]

An objection under Section 502(b)(6) does not attack the merits of the underlying state law claim. Rather, it seeks to limit the amount of the state law claim that may be allowed against, and recovered from, a bankruptcy estate.[10] The distinction is important.

If a bankruptcy court sustains a substantive objection to the merits of a landlord's state law claim — such as an objection based on the landlord's pre-bankruptcy breach of lease terms — that decision will likely have preclusive effect on the entire state law claim inside and outside of bankruptcy.[11]

In contrast, an objection strictly based on Section 502(b)(6), even when sustained, should have no preclusive effect on the balance of the state law claim. It is the latter concept that the Eighth Circuit relied on when it held that Section 502(b)(6) is not a viable defense to a Section 523 dischargeability claim.

The Bankruptcy Cases

Barbara Wigley's bankruptcy saga started in February 2014, almost three years before she filed her voluntary petition under Chapter 11, when her husband Michael Wigley filed his own petition under Chapter 11.[12]

Michael Wigley's bankruptcy was precipitated by the entry of a couple of large judgments against him.[13] The first judgment in excess of $2 million was on account of his personal guaranty of a commercial lease to Lariat Cos. Inc.[14]

The second judgment of $780,000 was on account of assets he transferred to his wife, prior to her filing for bankruptcy protection, while he was being sued on the commercial lease guaranty, and that judgment expressly found that the transfers were made with the actual intent to hinder, delay and defraud creditors.[15]

Once Michael Wigley was in bankruptcy, Lariat filed its $2 million plus state law claim against the estate, which claim was ultimately limited to $637,581.07 after application of Section 502(b)(6)'s cap.[16] Lariat's capped, allowed claim was subsequently satisfied in Michael Wigley's bankruptcy.[17]

Barbara Wigley then attempted to have the fraudulent transfer judgment against her vacated, based on the theory that the satisfaction of the capped claim in her husband's bankruptcy case meant she was off the hook — but a Minnesota state court denied that motion — leading her to promptly file her own petition under Chapter 11.[18]

Lariat then filed its state law claim in Barbara Wigley's bankruptcy case, which claim was still in excess of $1 million and made up of the fraudulent transfer judgment and applicable post-judgment interest.[19] Once again, because Lariat's state law claim ultimately arose from the breach of a lease, Section 502(b)(6) limited the allowed amount of Lariat's state law claim against the debtor's estate to $330,886.87, which claim was also satisfied in her

bankruptcy.[20]

But Lariat was not done there.

It also filed a dischargeability complaint against the debtor in the the U.S. Bankruptcy Court for the District of Minnesota, seeking to hold the balance of the state law claim that was disallowed under Section 502(b)(6) to be nondischargeable under Section 523(a)(2)(A) as debt obtained by actual fraud.[21]

The bankruptcy court agreed with Lariat that the balance of the state law claim was nondischargeable as debt obtained by fraud, and the debtor appealed.[22]

On appeal, the debtor contended that the bankruptcy court's rejection of her Section 502(b)(6) defense was an error as a matter of law because it constituted an inappropriate end-run around the cap limitations of Section 502(b)(6), while allowing the landlord to have an extra-large claim in direct contradiction of Section 502(b)(6)'s mandate.[23]

The Eighth Circuit disagreed, holding that the application of Section 502(b)(6) and the subsequent satisfaction of the allowed Section 502(b)(6) claim is not a defense to an action seeking to declare the disallowed portion of the state law claim to be nondischargeable.[24]

As noted above, the Eighth Circuit first explained why and what of Lariat's state law claim was viable and could still be asserted against the debtor despite the application of Section 502(b)(6).[25] Specifically, the Eighth Circuit stated:

The [state law] claim is for the total available [claim] under substantive non-bankruptcy law. In contrast, the [502(b)(6)] cap merely defines how much of the substantive claim will be "allowed" to be paid by the bankruptcy estate and mandates "disallowance" of the excess. Taken together, the claim and the cap yield the "allowed" or "allowable" claim.[26]

The Eighth Circuit then stated that the balance of a landlord's state law claim, that was disallowed against the bankruptcy estate solely on the bankruptcy principles set forth in Section 502(b)(6), even after the satisfaction of the allowed claim under Section 502(b)(6), is not a defense that precludes the balance of a state law claim from being excepted from discharge under Section 523.[27]

Conclusion

What is most unusual about the Wigley decision is the debtor's unique, albeit failed, attempt to use of Section 502(b)(6) as a defense to a dischargeability action.

And to its credit, the Eighth Circuit did not let the unusual nature of the argument distract it from well-settled and less novel principles that dictated its decision.

Specifically, the Eighth Circuit explained that Section 502(b)(6) is an objection based on bankruptcy principles alone, and does not affect the underlying merits of the claim. Accordingly, the answer to the important question of whether Section 502(b)(6) provides a defense to a dischargeability action, according to the Eighth Circuit, is "no."

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[1] 11 U.S.C. § 502(b)(6).

[2] In re Wigley (Lariat Companies. Inc. v. Barbara A Wigley), 15 F.4th 1208 (8th Cir. 2021).

[3] Id.

[4] Id. 11 U.S.C. § 523.

[5] Wigley, 15 F.4th 1208.

[6] § 502(b)(7) was re-designated § 502(b)(6) by the Bankruptcy Amendment and Federal Judgeship Act of 1984 (Pub. L. No. 98-353, 98 Stat. 333 effective July 10, 1984). See also, § 63(a)(9) of the Bankruptcy Act.

[7] In re Heller Ehrman LLP, 2011 WL 635224, *4 (N.D.Cal. 2011).

[8] 11 U.S.C. § 502(b)(6).

[9] "Historically, the limitation on allowable claims of lessors of real property was based on two considerations. First, the of the lessor's damages on breach of a real estate lease was contingent and difficult to prove." 1 Collier Pamphlet Edition 2020 (Richard Levin & Henry J. Somme reds., Mattew Bender), page 339.

[10] Wigley at 1212.

[11] Id.

[12] Id., at 1210.

[13] Id.

[14] Id.

[15] Id.

[16] Id.

[17] Id, at 1210-1211.

[18] Id., at 1211.

[19] Id.

[20] Id.

[21] Id.

[22] Id.

[23] Id.

[24] Id.

[25] Id., at 1211-1212.

[26] Id., at fn. 3.

[27] Id.