U.S. BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re: **MOUNTAINSIDE FITNESS CENTERS OF GILBERT,** **Debtor.**	In Chapter 11 proceedings. Case No.: 2:10-bk-23734-CGC Case No.: 2:10-bk-02823-CGC (Jointly Administered) **UNDER ADVISEMENT DECISION RE:** **R.S. LOTS, LLC'S PROOF OF CLAIM AGAINST MOUNTAINSIDE FITNESS CENTER OF GILBERT, LLC;** **and** **R.S. LOTS, LLC'S PROOF OF CLAIM AGAINST THOMAS J. HATTEN**
In re **THOMAS JOHN HATTEN,** **Debtor.**	

I. Introduction

Thomas Hatten ("Hatten") had a dream of owning his own gym and from humble origins made that dream into a reality. With nearly a dozen locations and thousands of paying members, Hatten built Mountainside Fitness Centers of Gilbert ("Mountainside") into a veritable fitness empire. But even the strongest empires are not immune to harsh economic realities. Tough times saw members that had been all too happy to pay for their memberships suddenly scale back on discretionary spending. Unable to cope with such a sharp decline in income, Mountainside breached its lease with its landlord, R.S. Lots, LLC ("R.S. Lots"). What was once the crown jewel of Mr. Hatten's empire, a three-and-a-half acre fitness mecca, now sits empty, abandoned by its former tenant. But it is not only Mountainside's corporate shell that R.S. Lots turns to for payment, but Mr. Hatten personally as guarantor of the lease. The question then becomes what do Mountainside and Hatten (collectively "Debtors") owe R.S. Lots to settle the score?

Because the two cases are inextricably linked and both parties present nearly the exact same arguments in both cases, the Court will address R.S. Lots' claim against both Hatten and Mountainside and treat them as essentially one claim. Obviously, R.S. Lots may not recover twice. With that in mind, there are three issues presented by the parties: 1) Does 11 U.S.C. § 502(b)(6) apply to Mountainside, Hatten or both? 2) If it does apply, when did the time period for the damage limitation begin to run? 3) Can the additional "triple-net" charges be considered "rent reserved" for purposes of § 502 (b)(6)?

I. Background & Facts

A. The Lease

In 2003, Mountainside entered into a fifteen year real property lease at 725 West Warner Road in Gilbert, Arizona ("Lease").[1] R.S. Lots is the current landlord. Hatten Holdings, Inc. and Thomas Hatten signed a guarantee of the Lease ("Guarantee"), which was to remain effective regardless of any insolvency, bankruptcy, or abandonment.[2] Minimum monthly payments were:

- Years 1-5: $33,468.75
- Years 6-10: $36, 826.25
- Years 11-15: $40,502.50
- (Option) 16-20: $44,540.00
- (Option) 21-25: $49,002.50

Lease 3.1(a).[3] Any past due payment incurs a 5% late fee ("late fee").[4] The Lease also provides that the minimum monthly rent is "net" to R.S. Lots and all triple-net type charges payable by Mountainside are "Additional Rent."[5] In the event of a default, R.S.

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[1] At the time, Mountainside went under the name Hatten Fitness Company of Gilbert, LLC. It changed its name in March 2003.

[2] The Guarantee was signed the same day as the Lease and is attached to all copies of the Lease filed with the Court.

[3] A copy of the Lease is attached to R.S. Lots' Response to Debtor's Objection to Proof of Claim as Exhibit A in the Mountainside case and Exhibit D in the Hatten case.

[4] Lease 37.

[5] Lease 3.1(b) ("It is mutually understood that the Minimum Rental is "net" to the Landlord, and that all additional rents, taxes and assessments (except Landlord's personal income taxes), maintenance costs, insurance and other charges, assessments and expenses required by the terms of this Lease to be paid by Tenant (*which amounts shall be deemed "Additional Rent" hereunder whether or not expressly designated*

Lots' non-exclusive remedies include the ability to terminate the Lease by written notice[6] and the ability to re-enter and attempt to relet the property without termination of the Lease.[7] Critically, the Lease says that without a signed writing from R.S. Lots, Mountainside could not surrender the premises before the end of the term.[8]

B. <u>Significant Dates in the Relationship Between R.S. Lots and Debtors</u>

- March 1, 2009—Mountainside fails to pay rent by due date.
- May 5, 2009—R.S. Lots serves Mountainside with a notice of default. By May 28, 2009, Mountainside abandons the premises.
- May 28, 2009—R.S. Lots brings a Forcible Detainer Action in the Maricopa County Superior Court.
- August 31, 2009—The superior court enters judgment in favor of R.S. Lots for $145,995.78 for rent due through August 31, 2009, as well as other fees.
- January 1, 2010—R.S. Lots brings a second state court action against Debtors for rent due from September 1, 2009 through April 2010.
- July 28, 2010—Mountainside files for chapter 11 bankruptcy.
- September 9, 2010—The Court enters an order rejecting the Lease from Mountainside's chapter 11 estate.
- September 16, 2010—Mountainside serves notice of removal of the second state court action to this Court.
- January 27, 2011—R.S. Lots files proof of claim against Mountainside for $1,144,753.78.
- March 23, 2011 The Court grants R.S. Lots partial summary judgment for rent due through April 1, 2010 for $414,336.62.
- February 2, 2012—The Court enters an Under Advisement Decision (the "UA Decision") against Mountainside for $874,378.99 for rent from April 2, 2011

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as such), shall be paid in addition to the Minimum Rental at the times and in the manner hereinafter provided. (emphasis added)).

[6] Lease 27.2(d).

[7] Lease 27.2(f).

[8] Lease 27.5.

through November 3, 2011, finding that Mountainside's surrender was never accepted by R.S. Lots.

- February 16, 2012—Hatten files for chapter 11 bankruptcy in his individual capacity.
- March 7, 2012—Mountainside files objection to the proof of claim.
- April 19, 2012—R.S. Lots files proof of claim against Hatten for $2,174,206.85.
- May 2, 2012—Hatten files objection to R.S. Lots' proof of claim.

C. Background

This order addresses two claims made by R.S. Lots: one against Mountainside, the other against Hatten. The Mountainside claim is a claim for breach of the Lease and was filed on January 27, 2011 for $1,144,753.78. Oral argument on this issue was held on May 2, 2012. The claim against Hatten arose out of the Guarantee. R.S. Lots filed proof of claim on April 19, 2012 for $2,174,206.85, which includes what R.S. Lots believes to be its § 502(b)(6) damages, damages awarded by the superior court in 2009, damages awarded by this Court in the UA Decision, as well as three months of rent from November 2011 (the end of the UA Decision damages) and February 2012 (Hatten's petition date). Because the legal analysis, facts, and the parties' arguments are substantially the same, the Court will address both claims as one.

Debtors contend that § 502(b)(6) limits any damages stemming from the breach of the Lease, that the damage limitation began to run was no later than August 31, 2009 (the date of the superior court forcible detainer judgment), and that the late fee is not additional rent and cannot be added to R.S. Lots' damages. For its part, R.S. Lots argues that § 502(b)(6) does not apply for two reasons: 1) § 502(b)(6) is not applicable in a one creditor case with no assets and; 2) the Lease was never terminated. Further, R.S. Lots argues that even if § 502(b)(6) does apply, the clock on damage limitation did not begin running until the petition date, and that the extra fees may be considered "rent reserved" under § 502(b)(6).

II. Analysis

A. 11 U.S.C. § 502(b)(6) Does Apply in This Case

Section 502(b)(6) contains a limitation on the "claim of a lessor for damages resulting from the termination of a lease of real property." Any claims resulting from the termination are capped at rent reserved "for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease following the earlier of—(i) the date of the filing of the petition; and (ii) the date on which the lessor repossessed, or the lessee surrendered, the leased property." 11 U.S.C. § 502(b)(6).[9] The cap's design allows a landlord who is the victim of a breach to recover some damages while preventing a claim so large that it wipes out all other unsecured creditors. *In re El Toro Materials Co., Inc.*, 504 F.3d 978, 980 (9th Cir. 2007). This cap does not apply to any unpaid prepetition rent. *Collier on Bankruptcy*, ¶502.03 (16th ed. 2012). This section of the Code places a cap on all damages arising out of the termination of a lease. *See, e.g. In re Storage Tech. Corp.*, 77 B.R. 824, 825 (Bankr. D. Col. 1986).

Though not discussed extensively by the parties, it is worth noting that the Ninth Circuit has held that the damage cap limitation of § 502(b)(6) is applicable to guarantors. A guarantee is "a secondary obligation and must be subject to the same limitations as the primary." *Arden v. Motel Part. (In re Arden)*, 176 F.3d 1226, 1229 (9th Cir. 1999). If R.S. Lots' claim against Mountainside is limited by § 502(b)(6), then its claim against Hatten would be as well.

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[9] Section 502 (b)(6) reads:
(b) 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—
. . .
(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds--
(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;

R.S. Lots first argues in the Mountainside case that since it is the only creditor with a sizable claim[10] and there are no assets to distribute, the policies underlying the statute are defeated and § 502(b)(6) has no application in this case. This is not written in the Code, nor is there any case law to that end. There is simply no basis to conclude that § 502(b)(6) only applies in cases with multiple creditors and/or assets. A creditor cannot rewrite the Code to fit its convenience.

By its plain language § 502(b)(6) applies only to leases which have been *terminated*. The question in this case is: what constitutes termination? While the acceptance of a surrendered lease would be a clear termination of a lease, the Court holds that rejection is also sufficient. Though there is no binding case law on this topic, for purposes of applying § 502(b)(6) courts have generally held that the rejection of a lease is tantamount to the termination of a lease.[11] Here, the Court signed the order rejecting the Lease on September 9, 2010; this constitutes termination under § 502(b)(6) and triggers the damage cap provision. To hold otherwise would leave § 502(b)(6) completely useless in the exact situation for which it was designed.

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[10] Mountainside disagrees with this and states that there is another creditor with a claim of over a million dollars. At any rate, the presence of another creditor is immaterial to the Court's ruling.

[11] James Lockhart, *Construction and Application of Bankruptcy Code Provision Limiting Lessors' Claims for Damages Resulting from Termination of Real Property Leases, 11 U.S.C.A § 502(b)(6)*, 58 A.L.R. Fed. 2d 13 (2011). *See, e.g., In re PCH Assoc.*, 804 F.2d 193 (2d Cir. 1986) ("Section 502(b)(6) limits the amount of damages that a landlord can recover upon breach or rejection of a lease of real property."); *In re Hotel Syracuse, Inc.,* 155 B.R. 824, 838 (Bankr. N.D.N.Y. 1993) ("when a debtor/tenant rejects a lease pursuant to Code § 365(d)(4), such rejection constitutes a breach of the lease under Code § 365(g), which brings Code § 502(b)(6) into effect"); *In re Hawaii Dimensions, Inc.,* 47 B.R. 425 (D. Haw. 1985). *See also Collier on Bankruptcy*, ¶502.03 (16th ed. 2012) ("Obviously, the rejection of a lease under section 365 is equivalent to a termination by breach."); *Norton Bankruptcy Law and Practice*, § 48:34 n.1 (3d ed. 2011) ("The damage limitations described in this section only apply to leases that are rejected."); Eric D. Winston, *Sizing Up the "Cap" Commercial Lease Rejection Claims in Bankruptcy*, 27 Cal. Bankr. J. 209 (2004) ("In effect, through Bankruptcy Code section 502(b)(6), Congress limited the amount of damages that a landlord could claim upon rejection of a lease."); Michael Lichtenstein, *Calculating a Landlord's Claim in Bankruptcy*, 32 Real Est. L.J. 131 (2003) ("Section 502(b)(6) of the Bankruptcy Code limits a commercial landlord's claim for lease rejection damages."). *But see, e.g., In re Storage Tech. Corp.*, 53 B.R. 471 (Bankr. D. Colo. 1986) (expressly rejecting the position of the *Hawaii Dimensions* court); *Matter of Garfinkle*, 577 F.2d 901 (5th Cir. 1978) (holding that the rejection of a lease was not a termination in large part because lessor/lessee were the same person and treating rejection as termination would have inequitably terminated a third party interest); *In re Picnic 'N Chicken, Inc.,* 58 B.R. 523 (Bankr. S.D. Cal. 1986) (rejection of a lease does not effect termination of that lease).

Even if Mountainside's rejection of the Lease is viewed as something short of termination, R.S. Lots' damages would still be capped by § 502(b)(6). "Even courts which do not accept that rejection of a lease equates with termination would limit all of the landlord's damage claims pursuant to § 502(b)(6) because that is the section dealing with claims by a lessor against the estate in bankruptcy." *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 102 (9th Cir. BAP 1995), *overruled on other grounds by In re El Toro Materials Co., Inc.*, 504 F.3d 978 (9th Cir. 2007). Even if Mountainside's rejection was not a termination under § 502(b)(6), the Panel's decision in *McSheridan* would preclude a full recovery by R.S. Lots.

This conclusion makes sense. To limit the cap's applicability only to circumstances under state law where a termination has occurred would distort its effect in bankruptcy cases and would undermine its underlying policies. If Congress had intended this result, it could have said so with clarity.

In short: the cap fits. The Court will apply it.

B. <u>The Time Period for the Damage Cap Began to Run on the Petition Date</u>

The damage cap provision of § 502(b)(6) begins to run "following the earlier of—(i) the date of the filing of the petition; and (ii) the date on which the lessor repossessed, or the lessee surrendered, the leased property." 11 U.S.C. § 502(b)(6). The precise meaning of the terms "repossessed" and "surrendered" for purposes of § 502(b)(6) is unclear. *In re Fifth Ave. Jewelers, Inc*., 203 B.R. 372, 377 (Bankr. W.D. Pa. 1996). Unlike the general applicability of the cap, these triggering dates are best understood in the context of applicable state law. Thus, because the terms deal with events that result from the termination of a lease of real property, they should be examined consistent with facts that effect a termination of a real property lease under state law. *Id.*

Under Arizona law, "[w]hen a lessee of a commercial lease abandons the premises, the lessor . . . may either refuse to accept the surrender of the lease, or he may accept the surrender." *Roosen v. Schaffer*, 621 P.2d 33, 36 (Ariz. Ct. App. 1980). *See also*

Dushoff v. Phoenix Co., 528 P.2d 637 (Ariz. Ct. App. 1974). A lease is not terminated if the surrender is not accepted; the lessor is then obligated to re-enter the premises and attempt to relet the premises. *Roosen,* 621 P.2d at 36. Merely bringing a forcible entry action does not effect repossession, nor an acceptance of a debtor's earlier surrender. *See In re Smith*, 249 B.R. 328 (Bankr. S.D. Ga.2000).

As discussed in the UA Decision, R.S. Lots did not accept Mountainside's surrender. Because there was no such acceptance, there was no termination of the Lease until *after* Mountainside's chapter 11 petition. Under Arizona law, the only other option available to R.S. Lots after Mountainside abandoned the premises was to re-enter and attempt to re-lease the building to mitigate damages.[12] The only legal tool available to R.S. Lots for re-entry was the forcible detainer statute. A.R.S. § 12-1117(A). Not only was R.S. Lots obligated under Arizona law to attempt to relet the building, but also specifically reserved the right to do so "*without termination* of this Lease." Lease 27.2(f) (emphasis added). R.S. Lots reserved the right to terminate the Lease upon default, but did not exercise this right.[13] Lease 27.2(d). The language is plain: without written notice, R.S. Lots could not terminate the Lease. Debtors cannot now argue that this reentry was a termination or repossession when the parties specifically agreed that it would not be considered as such. Paragraphs 27.2(d) and 27.2(f) are not one remedy—they are separate and distinct. Because there was neither an accepted surrender nor a repossession, the hands on the § 502(b)(6) clock did not begin moving until the petition date.

But that is only half the battle. Mountainside and Hatten have different petition dates—seven months apart. Whether R.S. Lots would receive 15% of the remaining time on the Lease or one year of rent depends on which petition date is used. The fifteen

[12] It is also worth noting that the property rights that Mountainside had under the Lease were never fully extinguished. Mountainside could have paid off the balance, made amends, and would have been able to resume business as normal, even after the Forcible Detainer Action. Until R.S. Lots relet the premises, Mountainside still had substantial property rights stemming from the Lease. *See In re Iron-Oak Supply Corp.*, 169 B.R. 414, 418 (Bankr. E.D. Cal. 1994) (holding that in principle a tenant who has abandoned a lease may cure a default). Possession was certainly the most important property right granted in the Lease, but was by no means the only one.

[13] Hatten and Mountainside seem to point at a letter from R.S. Lots' counsel which demands that Mountainside vacate the premises as evidence that there was in fact written notice of termination by R.S. Lots. Again, this speaks only to possession, not to termination of the Lease.

percent limitation is a measure of time remaining on a lease, not the amount of money owed. *In re Iron Oak Supply Corp.*, 169 B.R., 418 (Bankr. E.D. Cal. 1994). If more than eighty months remain on a lease, 15% will necessarily be the larger of the two statutory options because 15% of eighty is twelve months, or one year. *Id.* As of Mountainside's petition date, seven years and five months remained on the Lease; because eighty-nine months is greater than eighty months, the 15% figure is used. However, as of Hatten's petition date, only six years and one month remained; because seventy-three months is fewer than eighty months, R.S. Lots would be entitled to one year of rent reserved. Despite this, the parties have not addressed the issue. If the parties cannot agree which petition date should be used in calculating R.S. Lots' damages, the Court will require additional briefing on that issue. [14] The Court will not guess as to the position of the parties on an issue that they have not addressed.

Regardless of which petition date is used, any prepetition rent and damages are not limited by § 502(b)(6). *Collier on Bankruptcy*, ¶502.03 (16th ed. 2012). Because § 502(b)(6) deals only with rent reserved under the remainder of the Lease, any pre-petition rent, forcible detainer action damages, and the UA Decision damages are all unaffected by the damage cap.

Because there was neither an accepted surrender nor repossession, the damage limitation time period did not begin to run until the applicable petition date. In the absence of an agreement, the Court will not rule on which petition date applies without additional briefs from the parties. Any unpaid pre-petition rent, as well as any damages awarded by this Court or the superior court, are unaffected by the cap and are owed in full.

C. The Late Fee is not Rent Reserved

[14] The Court notes that in R.S. Lots' claim against Hatten, three additional months of rent between the end of the UA Decision (which awarded damages through November 2011) and Hatten's petition date (February 26, 2012) have been added to the claim. By doing this, R.S. Lots' claim against Hatten (the guarantor) is more than it would have been against Mountainside (the lessee), even though the damages for rent reserved under the Lease are actually less. That being said, the difference is somewhat trivial given the size of the damages Hatten and Mountainside involved. If the parties cannot come to an accord over approximately one month worth of rent, then, as with the petition date issue, they will need to submit additional briefs.

In order to be considered as "rent reserved" under § 502(b)(6):

1) 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;
2) The charge must be related to the value of the property or the lease thereon; and
3) the charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.

In re McSheridan, 184 B.R. 99—100. After initially contesting all the additional fees—insurance, taxes, CAM charges, management fees, and the late fee—Debtors have since stipulated to the inclusion of everything except the late fee as rent reserved.[15] The Court agrees with this and need not say anything more about these charges.

The late fee is a different story. Debtors do contest this fee's classification as rent reserved and therefore the Court must examine whether it may properly be included in R.S. Lots' damages. "[B]ecause . . . late fees fail the second and third prongs of the *McSheridan* test, they are not properly included as rent reserved under § 502(b)(6)." *In re PPI Enter. (U.S.), Inc.*, 228 B.R. 339, 350 (Bankr. D. Del. 1998), *aff'd on other grounds* 324 F.3d 197 (3d Cir. 2003). [16] While it can be argued whether or not the late fee is part of Debtors' original obligation, the late fee clearly fails the second and third prongs of the *McSheridan* test. The late fee is fixed, but by its very nature is not regular; it is not related to the underlying value of the leasehold; nor is it rent or something payable like rent—it is simply a late fee. Its only purpose is to provide incentive for timely payment. *Id.* Therefore, the late fee may not be included in R.S. Lots' § 502(b)(6) damages.

III. Conclusion

[15] Stipulated Briefing Schedule ¶4. Though the parties apparently disagree about the precise amount of the fees, the Court is confident that two sophisticated business entities can reach an agreement without the Court's intrusion into such matters. If the parties require further guidance on this issue, they will need to submit additional briefs on the issue.

[16] *But see In re Storage and Tech. Corp.*, 77 B.R. at 825 (stating in dicta that damages for "non-payment of rent" are limited by § 502(b)(6)). This Court finds *PPI* court's analysis of late fees under the *McSheridan* rubric to be more well-reasoned and thorough, and thus finds that the late fee is not rent reserved under § 502(b)(6).

The damage cap provision of § 502(b)(6) applies to R.S. Lots' claim, as rejection of a lease is termination for purposes of § 502(b)(6). Even if rejection is not viewed as tantamount to termination of the Lease, § 502(b)(6) would *still* limit any damages in line with the BAP's decision in *McSheridan*. The time period for damage limitations did not begin to run until the petition date, as under Arizona law there was neither an accepted surrender nor a repossession of the property. Finally, the late fee is not properly categorized as "rent reserved" and may not be awarded under § 502(b)(6).

Therefore, R.S. Lots' § 502(b)(6) damages consist of base rent and additional rent for the greater of one year or 15% of the remaining term of the Lease, calculated from the petition date. Any prepetition rent and damages awarded by this Court or the superior court not already paid are owed in full. R.S. Lots may recover from either Mountainside as lessor or Hatten as guarantor, but may recover only once. While the legal conclusions are clear, the math is not. If the parties cannot agree on whether the Hatten or Mountainside petition date applies, the exact amount of the additional rent, or any other matter, the Court will require additional briefing in order to render a decision. The parties will either provide a stipulation on the open issues within 14 days or submit a joint proposed briefing schedule.

Counsel for R.S. Lots is to upload a form of order.

Dated: June 26, 2012

So ordered.

CHARLES G. CASE II
UNITED STATES BANKRUPTCY JUDGE

COPY of the foregoing mailed by the BNC and/or
Sent by auto-generated mail to:

All creditors and interested parties.