Louisiana Law Review

Volume 82
Number 2 *Winter 2022*

Article 10

3-31-2022

Tipping the Cap to Practical and Equitable Considerations: The Supreme Court Should Refuse to Apply 11 U.S.C. § 502 (b)(6)'s Cap to Non-rent Damages

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INTRODUCTION

Imagine that you are the landlord of a $1 million piece of property in New Orleans, Louisiana. You rent the property out to a chemical manufacturing company for $100,000 per year. The chemical company begins experiencing financial difficulty, declares bankruptcy, and terminates the lease. Upon arriving at the property, you realize that the company's recklessness extended beyond its financial practices to its safety protocols. The company let dangerous chemicals seep into the ground, and as a result, restoring the property will cost $2 million. In this scenario, 11 U.S.C. § 502(b)(6) poses a threat to your financial wellbeing. Section 502(b)(6) allows for recovery of one to three years' worth of rent; however, the provision could limit your ability to recover damages beyond lost future rent.[1]

Specifically, 11 U.S.C. § 502(b)(6) sets a cap on landlords' recoverable damages if the claim is for "damages resulting from the termination of a lease of real property."[2] Although all courts that have faced this question apply the cap to cancelled future rent payments, they sharply disagree on whether to allow or cap non-rent damages such as maintenance expenses—resulting in three different approaches.[3] In the hypothetical presented above, if the Supreme Court adopts an approach using a broad interpretation of the § 502(b)(6) cap, you, as the landlord, will be liable for the cleanup with a limited ability to recover against the bankrupt debtor.[4] If they adopt an approach using a narrow interpretation, however, you could possibly recover some or all of the $2 million in damages from the bankruptcy estate of the tenant depending on the debtor's financial position.[5]

The harshest reading of § 502(b)(6), from the landlord's perspective, limits a landlord's recovery to only rent damages and caps the amount that landlords can recover.[6] A more moderate approach allows the landlord to claim non-rent damages but subjects those non-rent damages to the cap

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1. *See* 11 U.S.C. § 502(b)(6).

2. *Id.*

3. 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, 112 (2009).

4. *See* Kuske v. McSheridan (*In re* McSheridan), 184 B.R. 91 (B.A.P. 9th Cir. 1995).

5. *See* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 979 (9th Cir. 2007).

6. *See In re McSheridan*, 184 B.R. at 102.

along with rent damages.[7] The final, most lenient approach determines which damages to cap by determining what responsibilities the tenant would have if the tenant "assume[d] the lease rather than rejecting it."[8] Under this approach, landlords may claim both rent damages and non-rent damages, and the cap only limits a landlord's recovery of rent damages.[9]

The Supreme Court should adopt the final approach as promulgated in *In re El Toro* for determining which damages to cap under § 502(b)(6). Specifically, these courts should analyze whether "the landlord [would] have the same claim against the tenant if the tenant [had] assume[d] the lease rather than [terminating] it."[10] The *El Toro* approach is preferable because it adheres to the plain meaning of § 502(b)(6)'s text, furthers public policy goals by discouraging risky behavior and encouraging swift remedial efforts, and leads to more equitable recovery.

Part I of this Comment will review pertinent bankruptcy law, lease terminations, and their overlap. Part II will discuss the diverging interpretations of § 502(b)(6)'s cap from other jurisdictions and the arguments for each interpretation. Part III will review prior academic literature arguing in favor of the *El Toro* approach. Part IV will add to existing arguments in favor of the Ninth Circuit's *El Toro* approach. Specifically, it will argue why the Supreme Court should adopt the Ninth Circuit's test for determining damages based on canons of statutory interpretation, public policy considerations, and fairness.

I. BANKRUPTCY, LEASING, AND THEIR INTERSECTION

For the § 502(b)(6) cap to be at issue, the case must center on bankruptcy proceedings involving a lease termination.[11] As such, an overview of both topics is useful in understanding the issues present in the interpretation of § 502(b)(6). This Part begins with an overview of pertinent bankruptcy law, then discusses lease termination and its related concepts, and finally, categorizes damage types in a manner conducive to the § 502(b)(6) analysis.

7. *See In re* Mr. Gatti's, Inc., 162 B.R. 1004, 1013 (Bankr. W.D. Tex. 1994).
8. *In re El Toro Materials*, 504 F.3d at 981.
9. *See id.* at 982.
10. *See id.* at 981.
11. *See* 11 U.S.C. § 502(b)(6).

A. Bankruptcy Generally

When calculating how much a creditor, such as a landlord, can claim in bankruptcy proceedings, courts follow a two-step approach.[12] First, courts analyze what claims a creditor has against the bankrupt party.[13] The bankruptcy notion of a "claim" is broader than the traditional definition of a "claim."[14] Specifically, a bankruptcy claim is a "'right to payment' even if that right is still contingent or unliquidated."[15] Creditors may file a proof of claim during bankruptcy proceedings per 11 U.S.C. § 501.[16] State law or agreements between parties, such as leases, typically create these claims.[17]

Next, courts identify pertinent limitations on these claims.[18] Section 502 provides that claims are allowed unless a party in interest invokes one of the applicable § 502(b) exceptions.[19] For the instant analysis, § 502(b)(6) sets an upper limit on recovery for damages "resulting from the termination of a lease of real property."[20] The calculation for the cap adds one to three years' worth of rent reserved for the remainder of the lease to any unpaid rent due before the date of filing the petition or the date that the lessee surrendered the property.[21] Courts treat the amount that

12. Baxter, *supra* note 3, at 127.

13. *Id.*

14. David R. Kuney, *Protecting the Landlord's Rent Claim in Bankruptcy: Letters of Credit and Other Issues*, 29 NO. 6 PRAC. REAL EST. LAW. 17, 31 (2013).

15. *Id.* (referencing 11 U.S.C. § 101(5)(A)).

16. 11 U.S.C. § 501.

17. Baxter, *supra* note 3, at 161.

18. *Id.* at 127. The disagreement over whether the cap applies to limit a creditor's overall claim or specific claims that are then aggregated leads to diverging interpretations of the § 502(b)(6) cap.

19. 11 U.S.C. § 502(b)(6).

20. 11 U.S.C. § 502(b)(6) provides:

> [I]f 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.

21. *Id.*

the landlord can recover as an unsecured claim.[22] As such, landlords must generally recover on a pro rata basis alongside other unsecured creditors.[23]

B. Section 502(b)(6), Termination, and the Importance of State Law in Bankruptcy

Because the § 502(b)(6) cap limits claims "resulting from the termination of a lease," a precise understanding of the concept of "termination" is necessary.[24] The word "termination" in the Bankruptcy Code maintains its standard meaning.[25] It is "[t]he act of ending something; extinguishment" or "[t]he end of something in time or existence; conclusion or discontinuance."[26] There are two ways that a lease can be terminated: (1) the lease may provide that it terminates after a set period of time or (2) a party can affirmatively terminate the agreement by taking actions that terminate the lease according to the lease agreement or state law.[27]

The specific rules that apply to the termination of a lease are a matter of state law.[28] As such, state law dictates what circumstances authorize parties to terminate a lease and the process of termination that triggers the § 502(b)(6) cap.[29] In Louisiana, if a party fails to fulfill its obligations under a lease contract, the other party may terminate the lease.[30] Termination may also occur automatically.[31] Specifically, if a landlord uses abandoned property in a manner "contrary to the tenant's rights," then the landlord has terminated the lease.[32] Additionally, if a landlord breaches

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22. Kuney, *supra* note 14, at 34.
23. *Id.* at 32.
24. 11 U.S.C. § 502(b)(6).
25. Baxter, *supra* note 3, at 117.
26. *Termination*, BLACK'S LAW DICTIONARY (11th ed. 2019).
27. Baxter, *supra* note 3, at 117.
28. Eastover Bank for Sav. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1083 (5th Cir. 1994).
29. Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 751 (2001).
30. LEOPOLD Z. SHER ET AL., REAL ESTATE LEASING: LOUISIANA, Practical Law State Q&A 4567-5047 (2019) (citing LA. CIV. CODE art. 2719 (2021)) [hereinafter SHER ET AL., REAL ESTATE LEASING]. Civil Code article 2719 mirrors article 2013, which allows an obligee to dissolve contracts in general when the obligor fails to perform. LA. CIV. CODE art. 2013 (2021).
31. *Id.* (citing Richard v. Broussard, 495 So. 2d 1291, 1293–95 (La. 1986)).
32. *Id.*

the warranty of peaceful possession,[33] courts have the power to find that the landlord's actions amounted to an effective termination of the lease.[34]

If a tenant defaults on a lease obligation, the landlord has two options: terminating the lease or suing to enforce the lease.[35] If the landlord terminates the lease, he or she can recover for unpaid rent previously due but surrenders the right to collect rent after the date of termination.[36] The landlord may terminate the lease either through a court-ordered dissolution or, if the lease expressly allows, through notice to the tenant.[37] However, if the tenant's default is based on a technicality, good faith error on the part of the tenant, or substantial performance by the tenant, Louisiana courts may choose not to enforce dissolution on equitable grounds under the doctrine of judicial control.[38] Alternatively, if the lease allows, the landlord can sue to enforce the lease and recover for both past-due rent and accelerated future rental payments.[39]

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33. According to the Louisiana Civil Code, "[t]he lessor warrants the lessee's peaceful possession of the leased thing against any disturbance caused by a person who asserts ownership, or right to possession of, or any other right in the thing." LA. CIV. CODE art. 2700 (2021).

34. SHER ET AL., REAL ESTATE LEASING, *supra* note 30 (citing Essen Dev. v. Marr, 687 So. 2d 98, 99–100 (La. Ct. App. 1995)).

35. *Id.* (citing *Richard*, 495 So. 2d at 1293).

36. *Id.*

37. *Id.*

38. *Id.* (citing Edwards v. Standard Oil, 144 So. 430, 431 (La. 1932)); LEOPOLD Z. SHER ET AL., MANAGING COMMERCIAL REAL ESTATE LEASES: LOUISIANA, Practical Law State Q&A 1-567-9056 (2019) (first citing Karno v. Bourbon Burlesque Club, Inc., 931 So. 2d 1111 (La. Ct. App. 2006); and then citing Ergon, Inc. v. W.L. Allen, Sr., 593 So. 2d 438 (La. Ct. App. 1992)). However, by terminating the lease, the landlord would surrender the right to collect rent after the date of termination. SHER ET AL., REAL ESTATE LEASING, *supra* note 30 (citing *Richard*, 495 So. 2d at 1293). However, including a provision for stipulation of damages may help a landlord recover compensation that is similar to future rent as long as it is reasonable and not an impermissible attempt to collect future rent. *Id.* (citing Amacker v. Wedding, 363 So. 2d 223, 228 (La. Ct. App. 1978)).

39. SHER ET AL., REAL ESTATE LEASING, *supra* note 30 (citing *Richard*, 495 So. 2d at 1293). Louisiana law defines acceleration differently than § 502(b)(6). In Louisiana, a landlord accelerates rent by "declaring the rent for the remainder of the term immediately due." *Id.*

C. Termination vs. Breach vs. Rejection

Because the § 502(b)(6) cap applies to damages "resulting from the termination" of leased property, understanding the difference between termination and its related concepts is vital.[40] The concept of termination is related to the concept of breach in bankruptcy law.[41] Bankruptcy law maintains the common law definitions of both "breach" and "termination."[42] Specifically, a breach is a "violation or infraction of a law or obligation."[43] It is possible for a tenant to breach the lease without the lease automatically terminating.[44] The breach of an agreement by one party may allow the other party to terminate the contract, but breach does not necessarily result in termination.[45] As such, breach and termination are two distinct concepts in bankruptcy.

Likewise, the concept of termination is related to, but distinct from, the concept of rejection.[46] The Bankruptcy Code provides a trustee or debtor in possession two options for unexpired leases: assume the lease or do not assume the lease.[47] Rejection is the decision to not assume the lease.[48] Assumption occurs when the bankruptcy court and the debtor/representative of the bankruptcy estate agree to allow the debtor/representative to perform its obligations for the remainder of the lease as though it is a post-bankruptcy agreement.[49] Rejection of a lease constitutes a breach, but again, that breach does not necessarily terminate the lease.[50] Therefore, rejection and termination are distinct concepts, and rejection does not inherently lead to a termination. However, rejection does preclude the bankruptcy estate from maintaining the lease as a tenant.

D. The Three Categories of Damages

For the purpose of a § 502(b)(6) cap analysis, the potential damages a landlord may recover can be divided into three categories based on their

40. Baxter, *supra* note 3, at 116.
41. *Id.* at 117–21.
42. *Id.* at 117.
43. *Id.* (citing *Breach*, BLACK'S LAW DICTIONARY (8th ed. 2004)).
44. *Id.*
45. *Id.* at 118.
46. *Id.* at 117–21.
47. *Id.* at 118 (referring to 11 U.S.C. § 365(a)).
48. *Id.*
49. Winick, *supra* note 29, at 755.
50. Baxter, *supra* note 3, at 118.

relationship with the lease termination.[51] The first category is "termination damages," whose existence "results from" the termination of a lease.[52] Landlords have an obligation to mitigate damages that arise from cancelled future rent,[53] and doing so serves their best interests.[54] However, these mitigating actions create new costs like advertising and broker fees.[55] These additional costs are termination damages.[56] Specifically, termination is the "but for" cause of these damages.[57] In other words, had it not been for the termination of the lease, the landlord would not have incurred these additional expenses.[58]

The second category is "non-termination damages," which do not "result from" the termination of a lease.[59] Termination, in other words, does not cause the existence of these damages.[60] In these circumstances, the tenant would owe an obligation to the landlord regardless of whether a party terminated the contract.[61] In terms of "but for" causation, the tenant's obligation would still exist "but for" the termination. This category includes, for example, physical damage to the property that the tenant caused prior to terminating and would be required to repair either contractually or under law.[62]

The final category is "unpaid rent due"[63] before the earlier of "the date of the filing of the petition; [or] the date on which such lessor repossessed,

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51. *Id.* at 161.

52. *Id.* at 161–62.

53. LA. CIV. CODE art. 2700 (2021).

54. For a landlord trying to recover lost future rent from a bankrupt tenant, the tenant will either not have the assets to pay the landlord or the landlord's claim will be capped by § 502(b)(6). Because full recovery is unlikely from the tenant, a rational landlord would seek to recover by finding a new tenant.

55. Baxter, *supra* note 3, at 125.

56. *Id.*

57. For purposes of categorization, the Ninth Circuit's test in *El Toro* provides a clear standard for "but for" causation. Specifically, "[a]ssuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease [instead of terminating] it?" *Id.* at 123 (refining the Ninth Circuit's test from Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 979 (9th Cir. 2007)).

58. *Id.*

59. *Id.* at 161.

60. *Id.* at 125.

61. *Id.*

62. *Id.* at 162.

63. *Id.* at 161 (quoting 11 U.S.C. § 502(b)(6)).

or the lessee surrendered, the leased property."[64] Unpaid rent due before the termination is similar to non-termination damages in that its existence is not dependent upon termination of a lease.[65] However, it is helpful to break it into its own category because it is explicitly referenced in the cap calculation of § 502(b)(6)(B).[66] Unpaid rent due prior to the termination of the lease is different from future rent that would have come due later in the lease term. Future rent is universally considered to be a "but for" result of termination and is therefore subject to the § 502(b)(6) cap.[67]

II. CONFLICTING APPROACHES TO INTERPRETING THE § 502(B)(6) CAP

Courts disagree to what extent § 502(b)(6) allows recovery for non-termination damages and have developed three approaches.[68] As previously stated, the Ninth Circuit initially adopted the harshest application of § 502(b)(6) from the landlord's perspective, limiting the landlord's claim to rent expenses and subjects that claim to the § 502(b)(6) cap.[69] Under this view, § 502(b)(6) precludes all other damage claims, so non-termination damages, like property damage that predates the termination, could not be recovered under any circumstances.[70] The middle view allows a landlord to claim all damages, including non-termination damages, but limits the entire claim to the § 502(b)(6) cap.[71] Finally, the most lenient view, from the landlord's perspective, permits a landlord to make all claims, including for non-termination damages, such as reimbursement for property damage that the tenant caused.[72] Under this approach, now embraced by the Eighth and Ninth circuits, courts apply the cap to termination damages and future rent but not to the non-termination damages or unpaid rent due.[73]

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64. 11 U.S.C. § 502(b)(6)(A).

65. *See* Baxter, *supra* note 3, at 162.

66. 11 U.S.C. § 502(b)(6)(B).

67. Baxter, *supra* note 3, at 144.

68. Kuney, *supra* note 14, at 38.

69. *Id.*; *see* Kuske v. McSheridan (*In re* McSheridan), 184 B.R. 91 (B.A.P. 9th Cir. 1995).

70. Kuney, *supra* note 14, at 38; *see also In re McSheridan*, 184 B.R. 91.

71. Kuney, *supra* note 14, at 39; *see also In re* Mr. Gatti's, Inc., 162 B.R. 1004, 1014 (Bankr. W.D. Tex. 1994).

72. Kuney, *supra* note 14, at 38; *see also* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 979 (9th Cir. 2007).

73. Kuney, *supra* note 14, at 38; *see In re El Toro Materials*, 504 F.3d at 979; Lariat Cos. v. Wigley (*In re* Wigley), 533 B.R. 267, 271 (B.A.P. 8th Cir. 2015).

A. The McSheridan *Approach*

Courts that follow the *Kuske v. McSheridan* (*In re McSheridan*) approach only permit recovery of "rent reserved" damages and subject those damages to the § 502(b)(6) cap.[74] In *McSheridan*, the lease was a triple-net lease, meaning that the tenant was responsible for paying taxes, maintenance and repair expenses, insurance premiums, and utilities.[75] The lease at issue specified that the tenant was responsible for paying for repairs in a separate section rather than in the section titled "rent."[76] Rent was up to date, and the tenant surrendered the leased property before the trustee's rejection of the lease.[77] The landlord filed a claim for "repair and maintenance damages, insurance, utilities, and other expenses incurred after rejection."[78] The Ninth Circuit focused on the question of whether "rent reserved" included expenses that the contract did not designate as rent.[79]

In deciding the case, the *McSheridan* court adopted a two-step approach that greatly limited a landlord's opportunity to recover.[80] Although *McSheridan* was subsequently overruled by the Ninth Circuit, it helpfully illustrates the approach and its justifications, which is important because other courts have relied on its reasoning.[81] In the two step-approach, the first hurdle that a landlord's claim must clear is that it must be a claim for "rent reserved."[82] For a claim to qualify as rent reserved, it must satisfy three requirements.[83] First, the lease must categorize the payment as rent or additional rent, or the lease must specify that the payment is the tenant's obligation.[84] Second, the payment for the obligation must be related to the value of the leased premises.[85] Finally,

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74. *See In re McSheridan*, 184 B.R. at 102.
75. *Id.* at 94.
76. *Id.* at 95.
77. Baxter, *supra* note 3, at 154 (citing *In re McSheridan*, 184 B.R. at 95).
78. *Id.*
79. *Id.*
80. Kuney, *supra* note 14, at 38 (referencing *In re McSheridan*, 184 B.R. 91).
81. *See, e.g.*, *In re* Foamex Int'l, Inc., 368 B.R. 383 (Bankr. D. Del. 2007); New Valley Corp. v. Corp. Prop. Assocs. (*In re* New Valley Corp.), No. 98-982, 2000 WL 1251858, at *9–10 (D.N.J. Aug. 31, 2000).
82. Kuney, *supra* note 14, at 38.
83. *In re McSheridan*, 184 B.R. at 99–100.
84. *Id.*
85. For example, rent for a valuable piece of property is expected to be higher than rent for a cheap piece of property. In this way, the payment of the obligation is related to the value of the leased premise. *Id.*

the payment must be a "fixed, regular or periodic charge."[86] Even if a claim qualifies as rent reserved under the test, the Ninth Circuit created a second hurdle for a landlord's recovery: the recoverable amount for rent-reserved claims is limited by the cap set in § 502(b)(6).[87]

As support for this test, the court decided not to distinguish between damages occurring prior to termination and damages that are "caused" by termination for two reasons.[88] First, the court reasoned that Congress tailored the statute's focus to nonperformance of an obligation in the lease rather than termination's causation of the damage.[89] Second, all of the landlord's damages are due to nonperformance, so distinguishing as to the timing of nonperformance is irrelevant.[90] In other words, this approach ignores whether termination actually caused the injury and instead analyzes whether the tenant failed to perform one of its obligations under the lease.[91]

As support for these conclusions, the Ninth Circuit focused on the purpose of the § 502(b)(6) cap in a number of ways.[92] First, the court found that the purposes of the cap were to balance the landlord's interests against other creditors' interests and to prevent a windfall[93] at the expense of the other creditors.[94] By narrowing possible claims to only those that are for "rent reserved" and capping those damages, the *McSheridan* court limited a landlord's potential recovery and prevented windfalls.[95] Second, the court reasoned that because the rejection of a lease breaches every provision in it, and because § 502(b)(6) limits a lessor's damages resulting from rejection, the cap should apply to the claim for rent-reserved damages.[96] Finally, the Ninth Circuit relied on the cap's legislative history by analyzing the prior version of the cap, § 63a(9) of the Bankruptcy Act

86. For example, paying for the privilege to use property on the first of every month would satisfy this requirement as a periodic charge. *Id.*

87. Kuney, *supra* note 14, at 38 (referencing *In re McSheridan*, 184 B.R. 91).

88. *In re McSheridan*, 184 B.R. at 102.

89. *Id.*

90. Baxter, *supra* note 3, at 123 (citing *In re McSheridan*, 184 B.R. 91).

91. *See In re McSheridan*, 184 B.R. at 99–100. Critics of this argument counter that this approach improperly ignores the phrase "resulting from" in § 502(b)(6). *See id.* at 123.

92. *Id.* at 102.

93. A windfall is "[a]n unanticipated benefit . . . not caused by the recipient." *Windfall*, BLACK'S LAW DICTIONARY (11th ed. 2019).

94. *In re McSheridan*, 184 B.R. at 97 (relying on *In re* Leslie Fay Cos., Inc., 166 B.R. 802, 808 (Bankr. S.D.N.Y. 1994) and *In re* Atl. Container Corp., 133 B.R. 980, 985 (Bankr. N.D. Ill. 1991)).

95. *See In re McSheridan*, 184 B.R. 91.

96. *Id.* at 102.

of 1898.[97] The court found that Congress intended to limit the amount that a landlord could claim for damages resulting from rejection.[98] The Ninth Circuit equated the terms "rejection" and "termination," so it found that Congress intended to limit claims that occurred by a tenant's termination as well.[99]

In sum, the *McSheridan* approach equates the terms "rejection" and "termination," treats § 502(b)(6) as "effectively synonymous" with the prior version of the cap, and rejects the argument that the cap applies only to claims arising after termination because it attributes all damages to nonperformance.[100] Courts that follow this approach allow tenants who caused physical damage to the property to sidestep liability and pass it to landlords by capping the landlord's claim if the tenants terminate their leases and file for bankruptcy.[101] For non-landlord creditors, this approach boosts the potential amount of their recovery by limiting the landlord's claim.[102] Conversely, other approaches give landlords more protection at the shared expense of the non-landlord creditors.

B. The Mr. Gatti's *Approach*

Other courts allow a landlord to bring a wider variety of claims in bankruptcy proceedings, but aggregate the claims and subject the sum to the § 502(b)(6) cap.[103] This is different from the *McSheridan* approach of disallowing any non-rent-reserved claim and then capping those claims.[104] The Bankruptcy Court for the Western District of Texas's opinion in *In re Mr. Gatti's* serves as the seminal case for this approach.[105] *Mr. Gatti's* allows a broader array of claims, including non-termination claims, even if the cap amount is the same.[106]

In *Mr. Gatti's*, the tenant failed to maintain the premises and abandoned the property.[107] The contract obligated the tenant to pay rent on a periodic basis, pay ad valorem taxes and utility expenses, and perform

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97. *Id.* at 101.
98. *Id.*
99. *Id.* at 102.
100. Baxter, *supra* note 3, at 121 (first citing *In re* Mr. Gatti's, Inc. 162 B.R. 1004, 1013 (Bankr. W.D. Tex. 1994); and then citing *In re McSheridan*, 184 B.R. 91).
101. Baxter, *supra* note 3, at 113.
102. *Id.*
103. *See In re Mr. Gatti's*, 162 B.R. at 1014.
104. *See In re McSheridan*, 184 B.R. 91.
105. *See In re Mr. Gatti's*, 162 B.R. 1004.
106. *See* Kuney, *supra* note 14, at 38.
107. Baxter, *supra* note 3, at 149 (citing *In re Mr. Gatti's*, 162 B.R. at 1007).

maintenance and repairs.[108] According to the agreement, if the landlord terminated the lease upon the tenant's default, the landlord could demand damages and performance of any act that the tenant was obligated to do.[109] It further specified that the landlord could recover for his own expense in carrying out an obligation that the tenant failed to satisfy.[110] At issue was whether the § 502(b)(6) cap applied to repair damages in addition to other damages.[111]

The court focused on the prior version of the cap, § 63a(9) of the Bankruptcy Act of 1898, which limited "any damages resulting from the rejection of the lease."[112] They analyzed whether the old provision's use of the term "rejection" was equivalent to "termination" in the new provision.[113] The court agreed with the tenant that the legislative history, congressional intent, and past cases showed that the two terms were equivalent for purposes of § 502(b)(6) and thus ruled to cap the landlord's entire claim rather than just the termination damage component.[114] In other words, the court limited the landlord's piece of the pie that it could recover from the pizza chain.

Although the *Mr. Gatti's* approach differs from the *McSheridan* approach, they share some similarities.[115] Because the *Mr. Gatti's* court focused on the cap's applicability to repair damages rather than whether repair damages could be brought in the first place, the court illustrated that it did not use the *McSheridan* approach of allowing only rent-reserved claims.[116] Similar to the *McSheridan* court, the *Mr. Gatti's* court equated rejection with termination and found that § 502(b)(6) was synonymous with the previous version of the cap, which limited non-termination damages.[117] Additionally, both interpretations allow tenants who cause physical property damage to sidestep liability by passing it off in

108. *In re Mr. Gatti's*, 162 B.R. at 1006.
109. *Id.*
110. *Id.*
111. Baxter, *supra* note 3, at 149 (citing *In re Mr. Gatti's*, 162 B.R. at 1007).
112. *In re Mr. Gatti's*, 162 B.R. at 1008 (citing Oldden v. Tonto Realty Corp., 143 F.2d 916 (2d Cir. 1944)).
113. *Id.*
114. *Id.* at 1009.
115. *Compare In re Mr. Gatti's*, 162 B.R. at 1007 *with* Kuske v. McSheridan (*In re* McSheridan), 184 B.R. 91 (B.A.P. 9th Cir. 1995).
116. *See In re Mr. Gatti's*, 162 B.R. at 1007.
117. *Id.* at 1013.

bankruptcy proceedings.[118] The two are different in scope, but some courts have relied on both *Mr. Gatti's* and *McSheridan* in their decisions to limit landlord recovery.[119] The exact scope of the limitation that these courts follow is not entirely clear, but the language of the cases seems to indicate that they are more in line with the more lenient *Mr. Gatti's* approach.[120] Although the *Mr. Gatti's* approach is more favorable to landlords than the *McSheridan* approach, the Ninth Circuit produced the most landlord-friendly approach by distancing itself from *McSheridan* in *El Toro*.

C. The El Toro *Approach*

The final approach taken by courts is to allow landlords to bring claims for all damages and apply the cap to "termination" damages and future rent but not to "non-termination" damages.[121] The major case in developing this approach was *Saddleback Valley Community Church v. El Toro Materials Co.* (*In re El Toro Materials Co.*).[122] The case went to the Ninth Circuit, which had previously decided *McSheridan*.[123] In *El Toro*, the tenant filed bankruptcy to avoid $23 million in liability for removing tons of wet clay, equipment, and other materials.[124] If the court applied the § 502(b)(6) cap to the removal damages, the landlord would have only been able to recover $1 million.[125] Instead, the court allowed the landlord to bring its full claim in bankruptcy proceedings by adopting an approach that focused on the following question: "Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?"[126] In doing so, the court decided to reverse *In re McSheridan* "[t]o the extent that [it

118. *See id.* at 1007 (allowing tenants to avoid liability beyond the cap amount); *see also In re McSheridan*, 184 B.R. 91 (allowing tenants to categorically avoid liability for non-rent damages).

119. *See In re* New Valley Corp., No. 98-982, 2000 WL 1251858, at *9 (D.N.J. Aug. 31, 2000); *In re* Foamex Int'l, Inc., 368 B.R. 383, 385 (Bankr. D. Del. 2007).

120. *See In re New Valley*, 2000 WL 1251858, at *9; *In re Foamex Int'l*, 368 B.R. at 385.

121. *See* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 982 (9th Cir. 2007).

122. Baxter, *supra* note 3, at 158.

123. *In re El Toro Materials*, 504 F.3d 978.

124. *Id.*

125. Baxter, *supra* note 3, at 158.

126. *In re El Toro Materials*, 504 F.3d at 981. Supporters of this test point out that the test is correct, but the court erred by using the term "rejecting" where it meant "terminating." Baxter, *supra* note 3, at 159–60.

limited] tort claims other than those based on lost rent . . . or other damages directly arising from a tenant's failure to complete a lease term."[127]

The court in *El Toro* relied on a number of arguments to reach its conclusion.[128] It read the statutory language of "resulting from" to require "but for" causation.[129] According to the court, the facts in the case showed that the landlord's claim for removal and repair damages would have existed even if the tenant had assumed the lease instead of rejecting it, and therefore the court allowed the landlord's claim.[130] The court further relied on the language of § 502(b)(6) in reaching its decision by inferring that because rental payment contributes to the determination of the cap amount, the cap only limits recovery for loss of future rent.[131] The court continued by making a legislative intent argument, stating that capping non-termination claims would subvert the bankruptcy law goal of allowing parties to recover for an "aliquot share of the estate" to provide compensation to each creditor in proportion with what is owed.[132] Finally, the court made a policy argument by stating that allowing a tenant to cap its liability would create an unsavory incentive "for tenants to reject their lease" instead of assuming it or finishing the lease term.[133] Additionally, the court reasoned that under a broad application of the cap, tenants who had filed for bankruptcy and had exceeded the cap but not yet rejected the lease could cause more damage to the property without fear of liability.[134]

After *El Toro*, some courts, like the Bankruptcy Court for the Northern District of Ohio in *In re Brown*, adopted this approach.[135] Conversely, the Eighth Circuit in *In re Wigley* did not adopt the *El Toro* test explicitly but focused its analysis on whether the landlord would "have the same claim against the tenant if the lease had not been terminated."[136] Additionally, some cases decided before *El Toro* seem to align with it by default as a result of rejecting the *Mr. Gatti's* and *McSheridan* approaches.[137] However, since *El Toro*, commentators have disagreed over which approach a majority of jurisdictions follow.[138]

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127. *In re El Toro Materials*, 504 F.3d at 981–82.
128. *See id.* 980–81.
129. *Id.* at 982.
130. *Id.*
131. *Id.* at 980.
132. *Id.*
133. *Id.* at 981.
134. *Id.*
135. *In re* Brown, 398 B.R. 215, 219 (Bankr. N.D. Ohio 2008).
136. Lariat Cos. v. Wigley (*In re* Wigley), 533 B.R. 267, 271 (B.A.P. 8th Cir. 2015).
137. *See In re* Best Prods. Co., Inc., 229 B.R. 673, 678 (Bankr. E.D. Va. 1998).
138. Baxter, *supra* note 3, at 156 n.244.

III. PRIOR DOCTRINAL SUPPORT FOR THE *EL TORO* APPROACH

Supporting arguments for the *El Toro* approach include in-depth textual analysis of the phrase "resulting from the termination" and legislative history.[139] The textual analysis focuses on the use of the word "termination" in other places in the Bankruptcy Code and the plain meaning of the term "terminating."[140] The legislative history analysis disputes arguments that the history of the cap supports a harsh reading of § 502(b)(6) by tracing the cap's evolution, citing relevant case law, and identifying the source of confusion between the terms "rejection" and "termination."[141]

A. Plain Meaning

For the plain meaning argument, it is necessary to recall the distinction between the terms "breach," "termination," and "rejection."[142] First, § 365(h)(1)(A)(i) of the Bankruptcy Code allows a tenant to treat a lease as terminated when the rejection amounts to a breach that would entitle the tenant to treat the "lease as terminated by virtue of its terms."[143] Thus, the tenant may not terminate when the rejection does not amount to a breach that would permit the tenant to treat the lease as terminated.[144] The non-mandatory relationship between the rejection and the subsequent termination highlights the distinction between the terms.[145] Second, in 2005, Congress added § 562(a), which calculates damages for breach from the earlier of "the date of such rejection; or the date or dates of such liquidation, termination, or acceleration."[146] By specifically referring to "termination" and "rejection" in the same provision, Congress showed that the two words were different.[147] Finally, § 502(g) shows that termination is one possible consequence of rejection.[148] Therefore, rejection claims include, but are not limited to, termination claims.[149] Consequently, termination can arise from rejection, but rejection cannot arise from

139. *See id.* at 111.
140. *Id.*
141. *Id.*
142. *See id.* at 118.
143. 11 U.S.C. § 365(h)(1)(A)(i).
144. Baxter, *supra* note 3, at 119.
145. *See generally id.*
146. 11 U.S.C. § 562(a).
147. *See generally* Baxter, *supra* note 3, at 119.
148. *Id.*
149. *Id.* (referencing 11 U.S.C. § 502(g)).

termination.[150] These three arguments show that "rejection" and "termination" have different meanings in the Bankruptcy Code and are not interchangeable.[151] As a result, conflating the two terms, one of the central features of the *Mr. Gatti's* and *McSheridan* approaches, is conceptually improper.[152]

Additionally, the plain meaning of the phrase "resulting from" establishes a temporal and causative component that must be met for § 502(b)(6) to cap a particular damage.[153] This supports the proposition that § 502(b)(6) does not cap non-termination damages because, by definition, termination does not cause these damages.[154] For a consequence to "result from" a cause, the consequence must follow the cause in time; a consequence cannot precede its cause.[155] Additionally, the use of the phrase "result from" implies that the prior event caused the consequence.[156] Therefore, the phrase "resulting from the termination" limits the cap "only to damages *coming after* and *occurring because of* either party's termination of the lease, whenever the termination occurs."[157] As a result, the damages "resulting from" termination that § 502(b)(6) references can only occur after termination.[158] These "termination damages" arise out of and are caused by the termination.[159] According to an interpretation of the plain meaning of the text, damages that accrue prior to the termination cannot possibly be damages "resulting from" the termination.[160] Courts that follow the *McSheridan* and *Mr. Gatti's* approaches focus on nonperformance rather than timing and improperly ignore the phrase "resulting from."[161]

B. Legislative History

Scholars have also argued that the legislative history of the cap supports the *El Toro* reading.[162] Congress substantially changed

150. *Id.* at 119–20.
151. *Id.* at 121.
152. *Id.* at 157.
153. *Id.* at 122.
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 123.
161. *Id.*
162. *Id.* at 126.

§ 502(b)(6) in 1978, but the legislative reports are incomplete.[163] The cap's original enactment in the 1930s was more informative.[164] The original 1930s cap did not focus on the size of a landlord's claim.[165] The 1933 version of the law focused on creating a new category of recoverable damages for landlords rather than capping their possible recovery.[166] As such, that version of the law allowed future rent claims without any cap.[167] In 1934, Congress limited claims for future rent to the equivalent of a one- to three-year period.[168] The legislative history does not specify why it chose to cap these rent claims.[169] However, the Supreme Court's decision in *Manhattan Properties, Inc. v. Irving Trust Co.* from that time suggests that the changes were reactions to case law that sought to cover prospective damages, like termination damages, rather than non-prospective or non-termination damages.[170] Ultimately, the law capped a landlord's claim for "injury resulting from the rejection by the trustee of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease."[171] In sum, the legislative history from the 1934 changes suggests that Congress was not attempting to limit the "previously uncapped, provable, accrued, noncontingent, easily liquidated damages preceding bankruptcy."[172] In the following years, Congress made small edits to the cap's predecessor, but nothing in the legislative history supports applying the cap to damages that accrue before the termination.[173]

In 1973, the Commission on the Bankruptcy Laws of the United States proposed to cap a landlord's claim "for damages resulting from the termination of an unexpired lease of real property."[174] This proposal recommended changing the provision from capping damages that resulted from "rejection" to capping damages that resulted from "termination."[175] The Commission stated that it did not intend substantive change with its

163. *Id.*
164. *Id.* at 127.
165. *Id.*
166. *Id.* at 131.
167. *Id.* at 127.
168. *Id.*
169. *Id.* at 132.
170. *See* Manhattan Props., Inc. v. Irving Trust Co., 291 U.S. 320, 332 (1934).
171. Baxter, *supra* note 3, at 136 (citing Act of June 7, 1934, ch. 424, sec. 4(a), § 63(a)(7), 48 Stat. 911, 923–24) (emphasis removed).
172. *Id.* at 137.
173. *Id.* at 140.
174. *Id.* at 141–42 (citing REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 93-137 Part II, at 100 (1973)).
175. *Id.* at 142.

proposal.[176] Some courts, like the *Mr. Gatti's* court, understand the lack of intent to substantively change the provision's meaning to mean that § 502(b)(6) is "effectively synonymous" with the prior version of the cap.[177] These courts cap all damages, including those that accrued prior to termination.[178] However, critics argue that it appears that the legislative history from 1932 to 1978 does not show any congressional intent to do anything other than alter the common law rule to allow landlords to recover a limited part of their future rents.[179] Specifically, critics argue that because the prior versions of the statute were meant to cap prospective damages only, the revised language maintained that approach, and Congress focused on limiting prospective claims by landlords, not claims that accrued before bankruptcy proceedings.[180] Although the previous scholarship shows that both the plain language and legislative history support the adoption of the *El Toro* approach, more legal support for the *El Toro* test exists.

IV. HATS OFF TO *EL TORO*: THE SUPREME COURT SHOULD ADOPT A SLIGHTLY MODIFIED VERSION OF *EL TORO*

The existence of a circuit split on how to apply § 502(b)(6) illustrates that the Supreme Court has not resolved the issue regarding the interpretation of § 502(b)(6). Without an opinion creating a binding interpretation of § 502(b)(6), lower courts lack a clear approach when determining whether and how to apply the § 502(b)(6) cap to non-rent damages. Given the split approaches by several circuits, the lack of clear precedent creates harmful uncertainty at multiple levels. Specifically, such ambiguity leads to uncertainty for lower courts, litigants, landlords, tenants, and other creditors. Further, the existence of a circuit split across

176. *Id.*

177. *Id.* at 121.

178. *Id.* Baxter argues that the textual distinction between the old provision and the new provision leaves non-termination damages uncapped. *Id.* at 122. This emphasizes the importance of the textual argument that "resulting from" requires a temporal and causative component for two reasons. First, the plain language "resulting from" itself is direct support for reading § 502(b)(6) as not capping pre-termination damages. Second, Baxter concludes that the meaning of the statute's plain language is so clear that the drafters intended to cap damages traceable to premature termination and no other damages "arising under covenants whose violation is not caused by termination." *Id.* at 121–22.

179. *Id.* at 143 (citing *In re* Best Prods. Co., 229 B.R. 673, 678 (Bankr. E.D. Va. 1998)).

180. *Id.*

the country poses a problem even in circuits that have definitively adopted one of the approaches, because the litigants involved in those cases run a continued risk of the Supreme Court overturning the law that they follow.

The court in *El Toro* provided an overview of textual, policy, and purposive arguments in favor of the cap, which scholars supplemented with a more detailed analysis of the phrase "resulting from" and the legislative history.[181] The Supreme Court should adopt the *El Toro* approach but modify the language of the test by replacing the term "rejecting" with "terminating" to be more in line with the Bankruptcy Code's use of the terms.[182] Specifically, courts should resolve the question of whether to cap a specific damage by analyzing whether the tenant would have been liable had he or she assumed the lease instead of terminating it. In addition to the arguments set forth in *El Toro* and the other arguments regarding plain meaning and legislative history, the *El Toro* approach presents the best option because it is supported by canons of statutory interpretation, leads to more equitable outcomes, and promotes public policy goals by discouraging risky behavior and encouraging swift remedial measures.

A. Canons of Statutory Interpretation

Canons of statutory interpretation applied to § 502(b)(6) bolster the conclusion that the text of the statute supports the *El Toro* approach. First, the preference for narrowly interpreting exceptions supports this test. Additionally, the surplusage canon and the harmonious-reading canon rebut a potential counterargument against the *El Toro* approach.[183] These arguments add to the prior textual analysis of the § 502(b)(6) cap that focused more specifically on the plain meaning of the phrase "resulting from the termination."[184]

The *El Toro* approach to interpreting § 502(b)(6) is correct because it follows the canon that exceptions to a general statutory rule should be narrowly interpreted. Bankruptcy Code § 502(b) provides that "the court . . . shall determine the amount of such claim . . . except to the extent that" the following exceptions, including § 502(b)(6), apply.[185] The structure of § 502 and the plain language of § 502(b) show that the

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181. *See* Baxter, *supra* note 3; Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978 (9th Cir. 2007).

182. Baxter, *supra* note 3, at 161.

183. *See* Comm'r of Internal Revenue v. Clark, 489 U.S. 726, 739 (1989) (citing Phillips, Inc. v. Walling, 324 U.S. 490, 493 (1945)).

184. *See* Baxter, *supra* note 3, at 163.

185. 11 U.S.C. § 502(b).

§ 502(b)(6) cap is an exception to the general rule of allowing claims. For statutory interpretation, the Supreme Court has indicated its preference that courts should interpret exceptions narrowly.[186] Specifically, the Supreme Court cautioned that lower courts should be especially wary of extending an exception beyond its plain meaning.[187] There are two ways that courts can interpret the § 502(b)(6) cap: narrowly by following the *El Toro* approach in not capping non-termination damage claims or broadly by capping those claims, like the *Mr. Gatti's* approach. Courts should adopt the Ninth Circuit's current interpretation of § 502(b)(6) because it better aligns with the Supreme Court's preferred method of narrowly interpreting exceptions to a general rule. Because the plain language reading of § 502(b) does not apply the cap to non-termination damages and because the Court disfavors extending exceptions beyond their plain language, courts should adopt the *El Toro* approach.

One possible counterargument to the *El Toro* approach is that § 502(b)(6)(B)'s inclusion of "unpaid rent" in the cap calculation combined with the negative-implication canon limits a landlord's recovery for pre-termination claims to unpaid rent.[188] The negative-implication canon states that the expression or inclusion of one thing implies the exclusion of others.[189] In contrast, prior scholarly analysis emphasized the plain meaning of the phrase "damages resulting from the termination" in arguing for a narrow interpretation of the cap, like the *El Toro* approach.[190] The analysis showed that this phrase limits the cap's applicability to claims that came after the termination and whose damages shared a causal link to the termination.[191] However, § 502(b)(6)(B) presents the basis for a possible counterargument.[192] The provision adds "any unpaid rent due"

186. *Clark*, 489 U.S. at 739 (citing *Walling*, 324 U.S. at 493) ("In construing provisions . . . in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision.").

187. *Walling*, 324 U.S. at 493 ("To extend an exemption to other than those plainly and unmistakably within its terms and spirit is to abuse the interpretative process and to frustrate the announced will of the people.").

188. This counterargument was raised by Professor Louis Phillips in discussions with the author. Specifically, the negative-implication canon states that "[t]he expression of one thing implies the exclusion of others." ANTONIN SCALIA & BRYAN GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXT 107 (2012).

189. *Id.*

190. Baxter, *supra* note 3, at 122.

191. *Id.*

192. This counterargument was raised by Professor Louis Phillips in discussions on the topic.

under the lease to the rent reserved by the lease from § 502(b)(6)(A).[193] By including unpaid rent from before the termination in the cap, critics could argue that the cap applies to all damages that preexisted termination. Unpaid rent from before termination, by definition, accrued prior to termination. As such, it could not possess the temporal characteristic necessary to be "resulting from the termination." The inclusion of unpaid rent in the cap calculation, therefore, causes tension with the plain meaning interpretation of "resulting from" in the statute. If the authors of § 502(b)(6) felt that they needed to allow recovery for unpaid rent due specifically, that implies that non-termination expenses are generally not recoverable. Such an interpretation would lead the cap to apply to all non-termination damages and boost the recoverable amount by the unpaid rent.

There are two possible responses to this challenge that reconcile § 502(b)(6)(B)'s language and the adoption of the plain meaning of "resulting from."[194] First, according to other canons of statutory interpretation, § 502(b)(6)(B) should be read simply as a portion of the cap calculation, and courts should not extrapolate it to contradict the plain meaning of "resulting from."[195] The surplusage canon of interpretation states that "[i]f possible, every word and every provision is to be given effect. . . . None should needlessly be given an interpretation that causes it to . . . have no consequence."[196] Reading § 502(b)(6)(B) in a way that eliminates the temporal relationship between termination and "resulting from" damages would cause the phrase "resulting from the termination" to lose its effect.[197] Therefore, the surplusage canon supports the *El Toro* approach of limiting § 502(b)(6)(B)'s meaning to being part of the calculation of the cap rather than changing the meaning of "resulting from."[198]

Second, the harmonious-reading canon states that "provisions of a text should be interpreted in a way that renders them compatible, not contradictory."[199] This canon may seem inapplicable without first determining what "resulting from" means. However, the ordinary-

193. 11 U.S.C. § 502(b)(6).

194. *See* SCALIA & GARNER, *supra* note 188, at 174, 180.

195. *See id.*

196. *Id.* at 174.

197. *See* Baxter, *supra* note 3, at 158 (stating that the court in *In re McSheridan* ignored the phrase "resulting from.").

198. *See generally* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 981 (9th Cir. 2007) (ruling that the focus should be on what claims the landlord would have if the tenant had not terminated the lease).

199. SCALIA & GARNER, *supra* note 188, at 180.

meaning canon prevents this problem by specifying that "[w]ords are to be understood in their ordinary, everyday meanings—unless the context indicates that they bear a technical sense."[200] The verb "result" means for something "[t]o arise as a consequence."[201] Applying the ordinary-meaning canon, it is evident that the phrase "resulting from" has a temporal element.[202] Therefore, to avoid a contradictory interpretation between § 502(b)(6)(B) and the phrase "resulting from," courts should interpret the reference to unpaid rent as just a portion of the cap calculation with no deeper meaning and not as a cryptic way of contradicting the plain meaning of the phrase "resulting from."

Courts can and should follow the harmonious-reading canon by reading § 502(b)(6) as applying a cap only to rent and rent-related expenses, as the court did in *El Toro*.[203] The textual analysis, policy considerations, and legislative history covered in *El Toro* and other analyses bolster this conclusion.[204] The extent of damage that a tenant causes to property is weakly related to the amount of rent that a landlord charges.[205] To limit the recovery for property damage to an arbitrary amount would be irrational.[206] By specifically referencing "unpaid rent" in § 502(b)(6)(B), Congress restricted § 502(b)(6)'s applicability to rent and rent-related expenses.[207] The *El Toro* approach is rational given that rent and rent-related expenses are "the most obvious effect[s]" when a tenant terminates a lease, so they were likely the expenses at the forefront of the authors' minds at the time of drafting.[208]

In sum, traditional canons of statutory interpretation add to the preexisting textual support for adopting the *El Toro* approach when applying the § 502(b)(6) cap. The arguments grow out of and bolster the plain meaning of the phrase "resulting from the termination" and offer support for *El Toro*. In addition to the textual support, fairness concerns and policy goals weigh in favor of *El Toro* as well.

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200. *Id.* at 69.

201. *Result*, OXFORD ENGLISH DICTIONARY (3d ed. 2000).

202. *See* Baxter, *supra* note 3, at 122.

203. *In re El Toro Materials*, 504 F.3d at 982.

204. *See generally id.* at 978 (making policy and purposive arguments); Baxter, *supra* note 3 (making textual arguments and legislative history arguments).

205. *In re El Toro Materials*, 504 F.3d at 980.

206. *Id.* at 981.

207. *See generally id.* (adopting the interpretation of § 502(b)(6) that limited the cap to just rent and rent-related expenses).

208. Baxter, *supra* note 3, at 125.

B. More Equitable Outcomes

One focus of bankruptcy law is equitably distributing the scarce assets of a debtor among creditors.[209] The *El Toro* approach boosts equitability through effects both before the bankruptcy process begins and during the proceedings. First, adopting the *El Toro* approach can lead to increased equitability, even before bankruptcy proceedings, by incentivizing tenants to prevent property damage. Holding an entity liable for only its own fault and not the fault of others is a fundamental component of the American legal system.[210] The narrow interpretation will financially motivate tenants to be more cognizant of their actions, which will encourage them to prevent damage.[211] Preventing damage thereby prevents the need to repair the damage.[212] Tenants cannot use the § 502(b)(6) cap to pass liability for property damage to the landlord if no claim for damage exists in the first place.[213] Therefore, by incentivizing a tenant to avoid damaging the property, the narrow interpretation of the cap prevents shifting the burden of repair to the landlord who did not cause the damage.[214] Because fewer landlords would make claims for repair damages under this approach, the deterrence of damages also increases equitability to other creditors who would not have their claims reduced by a landlord's claim for repair damages.[215]

Additionally, the narrow interpretation of the cap advanced by *El Toro* bolsters equitability during the bankruptcy proceeding phase when the landlord seeks non-termination damages in bankruptcy. It is first necessary to recall the distinctions drawn between the categories of damages for lost rent, both past due and future; claims incurred through mitigating lost rent;

209. Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 80 (1995) (stating that bankruptcy is focused on balancing allocative efficiency with equity and justice).

210. *See, e.g.*, LA. CIV. CODE art. 2315 (2021).

211. *See* discussion *infra* Section IV.C.

212. *See generally Damage*, BLACK'S LAW DICTIONARY (11th ed. 2019) (explaining that damages are losses or injuries). Because there is no physical property damage in this circumstance, there is no "injury" from property damage.

213. *See* Baxter, *supra* note 3, at 127.

214. *See id.*

215. Admittedly, these unsecured creditors would also not have their claims reduced under a broad interpretation of the cap because the landlord's repair damage claim cannot be raised and would not dilute the recovery pool. However, the analysis that the narrow interpretation of the cap discourages damage shows that the difference in benefits to non-landlord creditors between the broad interpretation of the cap and the narrow interpretation is not as large as it may first seem.

and claims for non-termination damages.[216] Opponents of a narrow cap argue that it would lead to a windfall for the landlord at the expense of other creditors.[217] However, each of these categories is for distinct and separate damages that a landlord suffers, and allowing recovery for each type of damage does not produce a windfall for the landlord.[218] When viewing the damages according to their source, it is clear that leaving non-termination damages uncapped does not lead to a windfall for landlords.

The Bankruptcy Court for the Southern District of Ohio's decision in *In re Thompson* exemplifies the flaws of the "windfall" critique.[219] The court, motivated by fairness concerns, prevented the landlord from receiving "a substantial part of the property of the estate" because the landlord could mitigate his damages by finding a new tenant.[220] The court continued its fairness analysis by reasoning that because the landlord had received compensation through rent until bankruptcy and also would reacquire the leased property upon bankruptcy, it would be unfair to allow the landlord to recover for property damage at the expense of other creditors.[221]

The court's reasoning is flawed in its analysis of mitigated damages and in its reference to getting the original property back. First, the mitigation of damages analysis fails to recognize the distinction between the future loss of rent damage and the "non-termination" damages, like physical property damage that predated termination.[222] These two damages are distinct damages arising from different sources. By finding a new tenant to pay rent, the landlord would mitigate the lost future rent damage.[223] However, finding a new tenant would not mitigate the physical property damage.[224] As such, the court relied on a flawed premise.

Second, in basing its decision on the fact that the landlord would get the leased property back, the court ignored the fundamental characteristic of these cases—reduced property value due to damage. Rent income and

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216. *See* discussion *supra* Section I.D.

217. *See In re* Atl. Container Corp., 133 B.R. 980, 988 (Bankr. N.D. Ill. 1991) (explaining that lease claims may prevent recovery by other unsecured creditors).

218. *See* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 980 (9th Cir. 2007).

219. *In re* Thompson, 116 B.R. 610, 613 (Bankr. S.D. Ohio 1990) (citing *In re* Rodman, 60 B.R. 334 (Bankr. W.D. Okl. 1986)).

220. *Id.*

221. *Id.* (citing *In re Rodman*, 60 B.R. 334).

222. *See* Baxter, *supra* note 3, at 162.

223. *In re El Toro Materials*, 504 F.3d at 980.

224. In fact, finding a new tenant may necessitate repairs of physical property damage. *See* Baxter, *supra* note 3, at 112.

the extent of property damage are weakly correlated.[225] Therefore, there is no guarantee that past rental payments will cover the value of property damages. In fact, if the cost to repair the property or clean pollution exceeds the value of the property, the landlord could be receiving a net liability back.

Third, the fact that a landlord's claim may consume a "substantial part of the property" is irrelevant. By invoking fairness as a quality, the court begged the question of what "fair" means. Fairness is "[f]ree of bias or prejudice."[226] The court's conclusion that a landlord's claim should be capped because the claim would divert resources from other creditors is biased against the landlord because of his or her status as a landlord or biased against the claim for being large, over and above the statutory basis.[227] In other words, the court's decision is unfair by definition. It is fairer to leave the claim for property damage uncapped and then pay it proportionally with the other unsecured creditors.[228] Although it is true that allowing a landlord's uncapped claim for repair damages could reduce the claims of other creditors, dilution of other claims is the very nature of bankruptcy proceedings for scarce resources and could be stated about any claim.[229] As such, allowing the claim is fairer than capping it. [230]

The situation in *In re Bob's Sea Ray Boats, Inc.* illustrates the unfairness of capping non-termination damages.[231] In this case, the tenant ended a commercial lease, failed to repair damage on the leased premises, and breached a separate consulting agreement.[232] The process of ending the lease and leaving the property damaged is similar to the main series of cases like *El Toro*, *Mr. Gatti's*, and *McSheridan*; however, the separate consulting agreement highlights the unfairness of the situation.[233] In *Bob's*

225. *In re El Toro Materials*, 504 F.3d at 980.

226. *Fair*, BLACK'S LAW DICTIONARY (11th ed. 2019).

227. Imagine a scenario with two creditors. One holds $80,000 worth of the debtor's debt while the other holds $20,000 worth of the debtor's debt. Refusing to allow the creditor who holds a larger portion of the debt to make his claim or claims because that creditor would "consume a substantial portion of the debt" is inherently unfair.

228. *Order of Distribution in Bankruptcy*, PRAC. L. PRAC. NOTE 7-383-1336.

229. Because unsecured creditors recover on a pro rata basis, the addition of any claim without a corresponding increase in available assets necessarily decreases the share of recovery. *See* Kuney, *supra* note 14, at 32.

230. Baxter, *supra* note 3, at 113.

231. *See In re* Bob's Sea Ray Boats, Inc., 143 B.R. 229, 230 (Bankr. D.N.D. 1992).

232. *Id.*

233. *Compare In re Bob's Sea Ray Boats*, 143 B.R. at 230, *with* Saddleback Valley Cmty. Church v. El Toro Materials Co., (*In re* El Toro Materials Co.), 504

Sea Ray Boats, the Bankruptcy Court for the District of North Dakota found that the consulting agreement was totally separate and not capped by § 502(b)(6).[234] Under the language of the statute, the consulting agreement damages did not "result from" the termination of the lease itself, as is the case with the non-termination damages, which the court excluded from the § 502(b)(6) cap.[235] The court's approach in *Bob's Sea Ray Boats* supports the proposition that the analysis should distinguish between distinct types of claims and not lump all of a landlord's claims together.[236] This example makes a potential flaw in the *Mr. Gatti's* approach evident.[237] If courts lump all claims together and then cap the aggregate, like in *Mr. Gatti's*, incorporating a consulting agreement into a lease agreement would reduce the allowable claim for breach of the consulting agreement, simply because it is part of a lease agreement, through the triggering of the cap.[238] Therefore, the *Mr. Gatti's* approach is absurd because it unnecessarily creates the possibility that a landlord's claim for damages under an incorporated non-lease portion of a lease agreement would be capped as part of a lease claim.[239]

F.3d 978, 981 (9th Cir. 2007), *In re* Mr. Gatti's, Inc., 162 B.R. 1004 (Bankr. W.D. Tex. 1994), *and* Kuske v. McSheridan (*In re* McSheridan), 184 B.R. 91, 102 (B.A.P. 9th Cir. 1995).

234. *In re Bob's Sea Ray Boats*, 143 B.R. at 232.

235. *See* 11 U.S.C. § 502(b)(6).

236. *See In re Bob's Sea Ray Boats*, 143 B.R. at 230.

237. The court in *Mr. Gatti's* referred to the issue before them as being confined to whether damages "arising out of the lease agreement" are subject to the cap but did not explicitly limit the scope of § 502(b)(6) to the lease agreement during its analysis. *See In re Mr. Gatti's*, 162 B.R. at 1007. The court instead broadly concluded that § 502(b)(6) "limits a landlord's claim" against the estate once a debtor rejects the property. The use of the singular form of "claim" could be read as a landlord's overall claim comprised of an aggregate of smaller claims. *See id.* at 1013. Even if *Mr. Gatti's* is read to narrow the holding to only obligations arising from a lease agreement, that distinction does not undermine the illustration of the fundamental unfairness of the *Mr. Gatti's* approach. This is because the determination of whether a landlord should be able to recover for an injury is better determined by what the claim for damage is rather than what document created the obligation. *See generally* Baxter, *supra* note 3, at 127 (explaining the distinction between landlords and claims).

238. *See generally In re Mr. Gatti's*, 162 B.R. at 1013 (ruling that the cap applies "once a debtor rejects a previously unexpired lease").

239. *See generally* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 981 (9th Cir. 2007) (explaining that an approach that allows tenants to terminate a lease and cap unrelated damages would reduce operating value and deny the landlord's recovery).

Opponents of the *El Toro* approach may object to this argument by claiming that *Bob's Sea Ray Boats* is distinguishable. *Bob's Sea Ray Boats* focused on two separate contracts, the lease and the consulting agreement, rather than a single contract with two separate duties, payment of rent and repairing the damage, like in *El Toro*.[240] This distinction, however, does not create a substantive difference. Whether two duties originate from the same contract does not vitiate the fairness concern, because the focus should be on whether the injuries suffered by a party are distinct, rather than whether the injuries suffered arose from the same document.[241]

Additionally, opponents could argue that landlords can adjust rent prices to protect themselves from tenant damage and thus do not need the narrow application of the cap from *El Toro*. However, landlords may incorporate risk from the legal regime into their pricing whether the cap applies to non-termination damages or not, so adjusting rent prices to account for risk is not unique to a broad application of the cap.[242] Conversely, applying the § 502(b)(6) cap broadly would uniquely push rent prices higher because landlords would need to charge a risk-premium for the possibility of a tenant passing on damages.[243]

C. Discouraging Risky Behavior and Encouraging Swift Remedial Measures by Tenants in Furtherance of Public Policy

Narrowing the application of the cap would cause tenants who can survive bankruptcy to reduce their risk-taking and the damage they cause to the leased property.[244] As a result, landlords, tenants, and society would devote fewer resources to repairs, and liability for the repairs would be less likely to reach the landlord or other creditors that were not responsible for the damages. Even if this benefit does not alter the behavior of tenants

240. *Compare In re El Toro Materials*, 504 F.3d 978, *with In re Bob's Sea Ray Boats*, 143 B.R. at 230.

241. Baxter, *supra* note 3, at 127.

242. *See* Stephan A. Abraham, *5 Ways to Value a Real Estate Rental Property*, INVESTOPEDIA, https://www.investopedia.com/articles/mortgages-real-estate/11/how-to-value-real-estate-rental.asp [https://perma.cc/YB4K-2JT5] (last updated Sept. 26, 2020) (explaining that the Capital Asset Pricing Model incorporates the concept of rental risk to real estate investing).

243. *See generally* Adam Hayes, *Risk Premium*, INVESTOPEDIA, https://www.investopedia.com/terms/r/riskpremium.asp [https://perma.cc/9NZ4-UNM8] (last updated Feb. 19, 2020) (explaining that risk premium is the extra income that investors require to accept additional risk).

244. *See In re El Toro Materials*, 504 F.3d at 981.

who will not survive bankruptcy, it is still an overall benefit because of its positive effects on tenants who may survive bankruptcy.

Because the tenant would be less likely to escape liability by passing it off to the landlord, the threat of liability will disincentivize the tenant from damaging property.[245] In jurisdictions that follow *McSheridan* and *Mr. Gatti's* broad interpretations of the cap, tenants have the ability to pass repair damages to the landlord through bankruptcy and rejection.[246] Conversely, jurisdictions that adopt the *El Toro* approach, which does not limit a landlord's claim for non-termination damages, either pass liability to other unsecured creditors or keep it with the tenant.[247] Whether the liability for non-termination falls to the unsecured creditors or reverts back to the tenant depends on the financial position of the tenant. Under the *El Toro* approach, if the tenant will not survive bankruptcy, the cost of repair liability falls to unsecured creditors and dilutes their claims.[248] To prevent this dilution of claims from occurring, courts could require tenants who will survive bankruptcy to repair damages or compensate the landlord for damage repairs.[249]

A narrow interpretation of the cap would encourage tenants that will or may survive bankruptcy and tenants that would have survived bankruptcy but for the damage liability to avoid unnecessarily risky behavior because they would be liable for repairs. Deterring unreasonable behavior is a key justification behind awarding damages.[250] By eliminating the risk of a tenant having to pay for damages caused through their own fault, courts that follow *McSheridan* and *Mr. Gatti's* reduce the deterrent effect. Without the deterrent effect, tenants that plan on terminating the

245. *See id.*

246. Baxter, *supra* note 3, at 113.

247. *Id.*

248. *Id.*

249. *In re El Toro* provides an example of an entity planning on surviving bankruptcy. In the case, the tenant filed for bankruptcy to discharge its removal of waste liability as a strategic move. This strategic use of bankruptcy proceedings to discharge debt illustrates that companies can determine whether they will survive bankruptcy proceedings. *See id.* at 158 (referring to *In re El Toro Materials*, 504 F.3d at 979). Admittedly, a tenant will not always know whether it will survive bankruptcy; however, this line of reasoning extends to tenants who know they will survive and tenants who may survive who would not want to be stuck with liability if they do.

250. *See generally* Bellard v. Am. Cent. Ins. Co., 980 So. 2d 654, 669 (La. 2008) (referring to deterrence of wrongful conduct by the tortfeasor as a purpose of tort law and damages).

lease and filing for bankruptcy would be less inclined to reduce risk and care for the landlord's property in a reasonable manner.[251]

Discouraging risky behavior is beneficial from a public policy perspective and promotes fairness for the landlord and other unsecured creditors. In *United States v. Carroll Towing, Co.*, Judge Learned Hand developed a cost-benefit analysis to determine what duty an actor has in taking action or refraining from action, known as the Hand formula.[252] Analysis of the § 502(b)(6) interpretations through the lens of the Hand formula demonstrates the public policy benefits of adopting the *El Toro* approach because it better aligns the tenant's interests with the optimal outcome from a general, societal perspective than the *McSheridan* and *Mr. Gatti's* approaches.

When using the Hand formula, courts weigh the impacts of the expected damage from not acting in a certain manner against the cost of implementing a preventative measure or refraining from action.[253] The approach determines the expected loss by multiplying the probability of an injury by the "gravity of the resulting injury."[254] Courts set the value of damage in a particular case from the objective perspective of society rather than the subjective value to a specific party involved in the case.[255] Courts then compare the expected loss against the cost of preventing the injury.[256] If the expected injury is greater than the cost of preventing the injury, the party has a duty to prevent the injury.[257] Similarly, a rational economic actor may perform a personal cost-benefit analysis in deciding which course of action to take.[258] Because the *El Toro* approach does not limit a tenant's potential liability, a tenant's potential liability for property damage in jurisdictions that follow *El Toro* is unlimited.[259] Like the *El Toro* approach, analysis in the Hand formula does not have an arbitrary

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251. *In re El Toro Materials*, 504 F.3d at 981.

252. United States v. Carroll Towing, Co., 159 F.2d 169, 173 (2d Cir. 1947).

253. *See Carroll Towing*, 159 F.2d at 173.

254. *Id.* at 173.

255. Reasonableness is an objective standard rather than a subjective standard. The Hand formula determines reasonableness by relying on the value of some injury. Because the determination of reasonableness could not be objective if comprised of subjective analysis, the value of the injury is determined objectively rather than subjectively. *See id.*

256. *Id.* at 173.

257. *Id.*

258. Will Kenton, *Cost-Benefit Analysis*, INVESTOPEDIA (July 7, 2020), https://www.investopedia.com/terms/c/cost-benefitanalysis.asp [https://perma.cc/2QZZ-AUZA].

259. *See* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 981 (9th Cir. 2007).

cap on the possible "gravity of the resulting injury."[260] Conversely, the cap on recoverable damages in *McSheridan* and *Mr. Gatti's* limits the potential cost to a tenant and can result in a tenant having no incentive to prevent or repair damages that would be expected under the Hand formula.[261] The *El Toro* approach is preferable to the *McSheridan* and *Mr. Gatti's* approaches because it better aligns a tenant's incentives with the societally optimal course of action under the Hand formula.

McSheridan's and *Mr. Gatti's* broad reading of § 502(b)(6)—one that prevents recovery for pre-termination damages—creates a mismatch between society's policy preference and an individual actor's cost-benefit analysis. Specifically, a business may perform its own cost-benefit analysis and determine that the cap on non-termination damages causes its expected loss from repairing property to exceed its expected loss from refusing to repair the property.[262] In such a circumstance, the company would have no financial incentive to mitigate damages.[263] Instead, it would have a financial incentive to choose the cheapest means of achieving its goals whether it be through improper disposal of pollution or insufficient repairs.[264]

Because damage caps by their very nature limit an actor's liability, the Hand formula's societal "gravity of the resulting injury" would be higher than the entity's potential injury.[265] The probability of an injury to an entity is equal in the tenant's cost-benefit analysis and society's cost-benefit analysis because both probabilities refer to the same event—the occurrence of damage to the property.[266] This, combined with the fact that the *McSheridan* and *Mr. Gatti's* approaches limit a tenant's potential liability without limiting potential damages, causes these two approaches to under-incentivize tenants to prevent and repair property damage.[267]

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260. *See Carroll Towing*, 159 F.2d at 173.

261. *See In re* Mr. Gatti's, Inc., 162 B.R. 1004 (Bankr. W.D. Tex. 1994); *see* Kuske v. McSheridan (*In re* McSheridan), 184 B.R. 91 (B.A.P. 9th Cir. 1995).

262. For example, the tenant in *In re El Toro* had its potential liability under the cap as less than the cost of repairing the damage. *See In re El Toro Materials*, 504 F.3d at 979.

263. *See* Kenton, *supra* note 258.

264. *See id.*

265. *See generally In re El Toro Materials*, 504 F.3d at 981 (criticizing the cap for creating a perverse incentive for a tenant by eliminating liability for damage caused); *see also Carroll Towing*, 159 F.2d at 173.

266. *See Carroll Towing*, 159 F.2d at 173.

267. A simple cost-benefit multiplication formula from the tenant's perspective summarizes this conclusion. Relative to the optimal societal outcome, the tenant would conduct the following computation: less potential financial harm

Alternatively, the *El Toro* approach better aligns the tenant's interests with the societally desired outcome of how stringently to prevent property damage because it aligns the tenant's potential financial harm with the overall damage to society.[268] Because the likelihood of injury remains the same and the possible harms to society and the individual tenant are more aligned, the law will incentivize the tenant to pursue the best result for society.[269] Therefore, adopting the *El Toro* approach produces the best public policy outcomes by incentivizing individual tenants to act in accordance with the most favorable outcome under the Hand formula.

Because these claims focus on damage caused by the fault of the tenant, the tenant is in the best position to prevent the damage. It is a fundamental tenet of law that one should answer for his or her own fault and not the fault of another.[270] The *El Toro* interpretation of the cap promotes this tenet by reducing the likelihood that insolvent tenants will damage the property and pass liability to the landlord and by making solvent tenants liable.[271]

In addition to discouraging tenants from causing damage, the *El Toro* approach encourages tenants to take swift remedial measures in two ways. First, leaving the claims uncapped would remove the financial incentive to delay repairs in order to transfer liability to the landlord after termination during bankruptcy proceedings.[272] Like the Hand formula analysis applied to preventing damages in the first place, the *El Toro* approach better aligns a tenant's incentive to prevent property damage and repair property to the extent preferred by societal goals. Second, swift remedial efforts can reduce the cost of repair.[273] By leaving non-termination claims uncapped, courts will incentivize rational tenants that

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X same possibility of triggering financial harm = less incentive to take action and prevent the harm.

268. By refusing to cap non-termination damages, the *El Toro* approach exposes tenants to a greater amount of liability for damages that they cause that exceed the cap's value.

269. *See* Kenton, *supra* note 258.

270. *See, e.g.*, LA. CIV. CODE art. 2315 (2021).

271. *See* Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 981 (9th Cir. 2007) (explaining that the other approaches eliminate a tenant's fear of liability).

272. *See id.*

273. *See* Stone v. Safeco Ins. Co. of Am., 137 Wash. App. 1047 (2007) (referencing expert testimony that early remedial efforts can completely prevent mold after a water release).

can survive bankruptcy to fix the damage early when it is less expensive rather than waiting to let the damage and cost of repair grow.[274]

In determining how broadly to interpret the § 502(b)(6) cap, the Supreme Court should follow the *El Toro* approach but correct the terminology by replacing the term "rejecting" with the term "terminating."[275] Specifically, these courts should analyze whether the landlord would "have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it."[276] By doing this, courts will properly allow for recovery of "non-termination" damages and leave that recovery uncapped. In addition to the textual, historical, and policy support for this approach covered by past courts and scholars, the *El Toro* test presents a better approach to analyzing § 502(b)(6) than *McSheridan*, *Mr. Gatti's*, and their progeny because it comports with traditional canons of statutory interpretation, leads to more equitable outcomes by altering tenant risk and bankruptcy proceedings, and furthers public policy by aligning tenants' interests with overall societal interests.

CAPPING OFF

Without any further action by the Supreme Court, lower courts will continue to decide cases without a uniform and specific standard. This will simultaneously harm courts by reducing judicial efficiency in determining which approach to use; parties, who will spend more in litigating the disputes; landlords, who will bear the burden of increased uncertainty in these cases; and even tenants generally if landlords raise costs to offset their increased uncertainty. Although *McSheridan* and *Mr. Gatti's* present possible avenues for curing the uncertainty that exists currently, they present negative side effects that reduce the benefit of having a specific approach. In order to be faithful to the text of the statute, align with the legislative intent revealed through historical analysis, consider fairness concerns, and further societal policy goals, the Court should adopt the *El Toro* approach.

274. *See* Kenton, *supra* note 258.
275. Baxter, *supra* note 3, at 161.
276. *See generally id.* at 123.