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Damages-Penalty and Liquidation Damages Distinguished-

DAMAGES—PENALTY AND LIQUIDATED DAMAGES DISTINGUISHED—BANKRUPTCY—Claimant, as lessor, granted a lease containing the following clause: "The filing of any petition in bankruptcy—by or against the lessee shall be deemed to constitute a breach of this lease, and thereupon, *ipso facto* and without entry or other action by the lessor, this lease shall become and be terminated; and, notwithstanding any other provisions of this lease the lessor shall forthwith upon such termination be entitled to

recover damages for such breach in an amount equal to the amount of the rent reserved in this lease for the residue of the term thereof." The lessee having been adjudged a bankrupt, the lessor filed proof of debt for $5000.00 as damages for the breach of the lease. The lease was to run for two years at an annual rental of $4000.00. After nine months a petition in bankruptcy was filed against the lessee. *Held:* 1. The provision called for an unenforceable penalty. 2. The provision violated the "broad purpose" of the Bankruptcy Act and the claim asserted was not a provable debt. *Kothe v. R. C. Taylor Trust,* 50 Sup. Ct. Rep. 142. (Decided Jan. 6, 1930.)

There are a great number of Indiana cases which have dealt with the distinction between a penalty and liquidated damages. In *J. I. Case Threshing Machine Co. v. Souders,* 48 Ind. App. 503, 96 N. E. 177, the court said: "Whether the amount stipulated in a contract to be paid by a party upon failure of performance is to be treated as liquidated damages or as a penalty has been a fruitful source of litigation, and the subject of much judicial interpretation." . . . "A contract that fixes a certain sum as liquidated damages for its breach is valid where such amount is reasonably proportionate to the actual damages sustained." See also *Jaqua v. Heddington,* 114 Ind. 309, 16 N. E. 527; *Zenor v. Pryor,* 57 Ind. App. 222, 106 N. E. 746. The rule announced in these cases has no application to a provision for the forfeiture, in the event of a default, of installments already paid. *Miller v. Fletcher Savings & Trust Co.,* 78 Ind. App. 183, 133 N. E. 174. "Where there is doubt as to whether a sum specified to be paid on breach of a contract was intended as liquidated damages or a penalty, the courts favor that interpretation which makes such sum a penalty." *Zenor v. Pryor, supra.* We have no doubt that the rule announced by the Supreme Court of the United States is in accord with the decided weight of authority in Indiana. It is submitted that had this case arisen in our state courts the result would have been the same. 17 C. J. 933 *et seq.*

The court might have stopped here and based its decision upon the ground that the provision in the lease stipulated for an unenforceable penalty and could not be a "provable claim" within the meaning of the Federal Bankruptcy Act and that a court of equity will give relief against it. *In re Scholtz-Mutual Drug Co.,* 298 Fed. 539. The court, however, assigned another reason, saying: ". . . The parties were consciously undertaking to contract for payment to be made out of the assets of a bankrupt estate—not for something which the lessee personally would be required to discharge. He, therefore, had little, if any, immediate concern with the amount of the claim to be presented; most probably, that would affect only those entitled to share in the proceeds of property beyond his control." The court then said that this violated the "broad purpose" of the Bankruptcy Act and that it was "plain enough that the real design of the challenged provision was to insure to the lessor preferential treatment in the event of bankruptcy."

It is to be noted that the court did not say that the provision in question was invalid. This raises some nice questions with regard to leases in bankruptcy proceedings. A few general rules may be briefly stated. 1. If the bankrupt is a tenant of the leased premises, his interest in the

unexpired term of the lease will constitute assets of the estate in bankruptcy and pass to the trustee. *Crowe v. Baumann*, 190 Fed. 399; *Olden v. Sassman*, 68 N. J. Eq. 799, 64 Atl. 1134; *Wildman v. Taylor*, Fed. Cas. No. 17,654. 2. The trustee is not bound to assume a lease made to the bankrupt unless he thinks it will be for the benefit of the creditors; he has an option either to accept it or abandon it. *In re Chambers, Calder & Co.* 98 Fed. 865; *In re Frazin*, 183 Fed. 28; *Summerville v. Kelliher*, 144 Cal. 155, 77 Pac. 889; but the option must be exercised, title not passing automatically. *In re Kreiger*, 15 Fed. (2d) 90, affirmed, 16 Fed. (2d) 554. Nor can a landlord file a claim for damages arising out of the trustee's refusal to take up the lease. *Slocum et al. v. Soliday*, 183 Fed. 410; *In re Shaffer*, 124 Fed. 111; *In re Roth and Appel*, 181 Fed. 667. 3. A lessee's covenant not to assign, mortgage, or pledge the lease, or underlet the property, without the lessor's consent, is not violated by the lessee's bankruptcy. *In re Frazin*, 174 Fed. 713; *In re Bush*, 126 Fed. 878; *In re Prudential Lithograph Co.*, 265 Fed. 869, affirmed 270 Fed. 469, and *certiorari* denied *Samuel Vernon Estate v. Lyttle*, 41 Sup. Ct. Rep. 534, 256 U. S. 692; *In re Tidus*, 4 Fed. (2d) 558; *Armour & Co. v. Callahan*, 25 Fed. (2d) 548; *In re Ehehardt*, 19 Fed. (2d) 406; *Gazlay v. Williams*, 210 U. S. 41, 52 L. Ed. 950, 28 Sup. Ct. 687. 4. A clause in a lease providing for forfeiture if a receiver or trustee "shall be appointed of the lessee's property" was held to be valid as against a trustee in bankruptcy in *In re Scholtz-Mutual Drug Co.*, 298 Fed. 539; *Empress Theatre Co. v. Horton*, 266 Fed. 657; *In re Georgalas Bros.*, 245 Fed. 129; *Galbraith v. Wood*, 124 Minn. 210, 144 N. W. 945; *In re Frazin, supra; Jandrew v. Bouche*, 29 Fed. (2d) 346; *Sproul v. Help Yourself Store*, 16 Fed. (2d) 554. See also *In re Famous Fain Co.*, 10 Fed. (2d) 540. We call particular attention to the fourth classification since we are informed that the rule announced in the cases therein listed is not followed generally in the Federal courts of Indiana. Can the principal case be taken as an authority in favor of the validity of such a provision as against the trustee?

The principal case raises the further question as to whether rents to accrue in the future are provable debts within the meaning of the Bankruptcy Act. The claim here asserted was held by the Circuit Court of Appeals for the First Circuit to be valid and allowable under section 63a (4) of the Bankruptcy Act of 1898, 30 Stat. 563 (U. S. C. A. title 11, c. 7, paragraph 103 (a); see 30 F. (2d) 77). The Supreme Court of the United States did not pass upon this question as the case was there decided upon the ground that the provision in the lease called for a penalty. It is submitted that the weight of authority is against the Circuit Court on this point. See Collier on Bankruptcy (ninth edition), page 878 *et seq.* and the cases cited there. At page 880 of this volume we find the following statement: "It has been held that a covenant in a lease, making rent for the entire period fall due upon a breach by the lease (lessee?), creates a fixed liability within the meaning of Sec. 63a (1)." In support of this statement *Matter of Pittsburgh Drug Co.*, 164 Fed. 482, and *Martin v. Orgain*, 174 Fed. 772, are cited as authorities. We shall not extend this note with a detailed analysis of the last two cases, other than say that each of the cases turned on a state statute which came within the contemplation of Sec. 64b (7) of the Bankruptcy Act, giving priorities to

claims having such priority under the "laws of the States of the United States." The decision in *In re Pittsburgh Drug Co.* is based upon the interpretation which the Pennsylvania court gave to the state statute in *Platt v. Johnson*, 168 Pa. 47, 31 Atl. 935. The case of *Martin v. Orgain* arose in the Federal Court of Texas. For an interpretation of the Texas statute see *Marsalis v. Pitman*, 68 Tex. Rep. 624, 5 S. W. 404. *In re Pittsburgh Drug Co.* and *Martin v. Orgain* are further distinguishable upon the ground that the petition in bankruptcy was not the only breach, but the lessee was in arrears and thus in default. The distinction that we are attempting to make here is plainly shown by the *Orgain* case where the recovery was limited to one year's rent as set out in the state statute, whereas the lease itself was to extend for more than three years. See also *Lontos v. Coppard*, 246 Fed. 803, another Texas case. See also 7 C. J. 295. The property passed to the trustee burdened with a valid lien, *York Mfg. Co. v. Cassell*, 201 U. S. 344, 25 Sup. Ct. 481. T. R. D.