

LEASES

THE EFFECT OF BANKRUPTCY ON LETTERS OF CREDIT AS SECURITY FOR REAL PROPERTY LEASES

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Landlords frequently require letters of credit as a security deposit or as credit enhancement when leasing real property. It is, however, unclear how those letters of credit will be treated in the event the tenant files for bankruptcy protection under the United States Bankruptcy Code.¹ The courts in three different judicial Circuits have examined the issue and all three have reached different results. Most recently, the Fifth Circuit Court of Appeals added its voice to the debate. The court's ruling in *In re Stonebridge Technologies, Inc.*² is the latest decision on the topic and may have provided a limited opening for landlords to recover lease rejection damages in excess of the cap imposed by Bankruptcy Code section 502(b)(6).

SECTION 502(B)(6)

When a party files for bankruptcy, it becomes a "debtor." Debtor-lessees have the ability to reject real property leases pursuant to section 365 of the Bankruptcy Code. The rejection of a real property lease is essentially a breach of the lease and it gives rise to a general unsecured claim held by the landlord against the estate for damages resulting from the lessee's breach. Bankruptcy Code section 502(b)(6), however, provides that a landlord's lease rejection claim is limited to the amount of any accrued but unpaid rent plus the rent reserved under the lease for the greater of: (i) one year, or (ii) 15 percent of the remaining term of

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1. 11 U.S.C. § 101, 1532.

2. *EOP-Colonmade of Dallas Limited Partnership v. Faulkner (In re Stonebridge Technologies, Inc.)*, 430 F.3d 260 (5th Cir. 2005).

the lease (not to exceed three years). The so-called “502(b)(6) cap” is imposed to prevent lease rejection claims from overwhelming the claims pool to the detriment of every other creditor. In common practice, the landlord calculates gross damages sustained as a result of the debtor’s rejection of the lease and then applies the 502(b)(6) cap to the gross figure to arrive at the amount of the claim that may be allowed.

To illustrate this principle, if a tenant signs a ten-year, \$1000/month lease and then files for bankruptcy at the beginning of year three, the landlord would have a gross claim of \$96,000 (eight full years remaining on the lease at \$12,000 per year). After the imposition of the 502(b)(6) cap, however, the claim would be limited to \$14,400 (15% of the remaining term of the lease). Assuming that the lessee was completely current on its rent payments when it filed for bankruptcy, \$14,400 would be the maximum amount the landlord could recover against the estate.

SECURITY DEPOSITS

Landlords almost always require a security deposit in connection with a lease of real property. As a general rule, courts have held that these security deposits provided by the debtor-lessee must be applied to the lease rejection claim after imposition of the 502(b)(6) cap — not to the landlord’s actual or total gross claim. Accordingly, the landlord’s rejection claim is limited to the damage amount as capped by section 502(b)(6), less the amount of any security deposit retained by the landlord.

Using the earlier example to illustrate this principle, if the hypothetical tenant described above provided a \$2000 “First and Last” security deposit when it entered into its ten-year lease and the landlord drew upon the full \$2000 upon the tenant’s bankruptcy filing, by law that \$2000 would be applied to the landlord’s claim as capped by the statute. The landlord’s claim against the estate would therefore be limited to \$12,400 (the \$14,400 capped claim minus the amount of the deposit). The law is clear that the landlord would not be able to simply keep the \$2000 it held as a security deposit and still assert a claim for \$14,400 against the estate. What is not clear, however, is whether a landlord must apply the proceeds from a letter of credit in the same manner as a security deposit.

LETTERS OF CREDIT — THREE DIFFERENT COURTS, THREE DIFFERENT APPROACHES

Three courts in three different judicial circuits have addressed this issue and all three have reached a different result, yet the fact pattern in all three cases was remarkably similar. In all three, the debtor as lessee entered into a pre-bankruptcy lease and provided the landlord a letter of credit as a credit enhancement for its obligations under the lease. Upon filing for bankruptcy, the debtor rejected the lease and the landlord either immediately drew upon or subsequently drew upon the letter of

credit to recover some of its damages. The similarity stops, however, when the courts address whether the landlord may apply the proceeds to the gross claim over and above the cap. As explained in detail below, each of the three courts adopted a different analytical approach before reaching a conclusion.

PPI Enterprises

The first case to squarely address the issue is *In re PPI Enterprises (U.S.) Inc.*³ In this case, the landlord had a gross rejection damages claim against the debtor in the amount of approximately \$4.7 million. After applying the provisions of section 502(b)(6) to the gross rejection damages claim, the allowed claim was reduced to approximately \$860,000. The landlord had been given and drew down upon a letter of credit in the amount of \$650,000. The issue before the court was whether to apply the proceeds from the letter of credit to reduce the amount of the capped claim to approximately \$210,000 (\$860,000 capped claim minus the \$650,000 in letter of credit proceeds), or to apply the proceeds to the gross claim over and above the cap which would still leave the landlord with a claim amount of approximately \$860,000.

In reaching its decision, the Third Circuit first noted that it was generally inclined to treat letters of credit in the same manner as security deposits and apply the proceeds to the landlord's claim as capped by section 502(b)(6). However, the court held that it did not need to make such a blanket declaration in this case because the language of the lease in question expressly required the debtor to provide the landlord with a standby letter of credit under the lease instead of a cash security deposit. After interpreting the language of the lease, the court concluded that the parties intended the letter of credit to serve as a security deposit.⁴ Thus, the court affirmed the lower court's decision to apply the proceeds of the letter of credit to reduce the landlord's claim as capped by section 502(b)(6). In light of the court's initial inclination to treat letters of credit as security deposits for purposes of the 502(b)(6) cap, it likely would have reached the same result even in the absence of the express lease terms. The language of the lease, however, allowed the court to make a finding as to the intent of the parties and thus limit the decision to the facts of the case before it.

Mayan Networks

The Ninth Circuit Bankruptcy Appellate Panel subsequently addressed the issue in *In re Mayan Networks Corp.*⁵ In this case, the landlord's

3. *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003).

4. *Id.* at 210.

5. *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (B.A.P. 9th Cir. 2004).

rejection damages claim against the debtor, after applying the 502(b)(6) cap, totaled approximately \$1.7 million. The landlord had been given a standby letter of credit at the inception of the lease in the amount of \$650,000, which was secured by a cash account held by the lessee. Even though the fact pattern was similar, the Appellate Panel in *Mayan Networks* expressly declined to follow the Third Circuit's rationale in *PPI Enterprises*. Instead, the Ninth Circuit focused more on the fact that the letter of credit was secured by a cash deposit. The court noted that the landlord's draw upon the letter of credit had the same practical effect on the estate as the forfeiture of a cash security deposit. As a result, the court held that the proceeds of the letter of credit should be applied to the landlord's claim as capped by section 506(b)(6). The landlord's claim was therefore reduced to approximately \$1.05 million.

Stonebridge Technologies

Finally, in *In re Stonebridge Technologies, Inc.*, which was decided in late 2005, the Fifth Circuit Court of Appeals addressed the issue and diverged from the separate reasonings employed by the *P.P.I Enterprises* and the *Mayan Networks* courts. In *Stonebridge*, the lessee provided the landlord a cash security deposit of \$105,298 and a standby letter of credit in the amount of approximately \$1.4 million. When the lessee filed for bankruptcy and rejected the lease, the landlord drew on the letter of credit, but never filed a proof of claim for its rejection damages. The landlord chose not to file a proof of claim because the amount of the security deposit together with the letter of credit proceeds exceeded the amount of the landlord's rejection damage claim as capped by section 506(b)(6). The trustee of the lessee's estate sued the landlord in the bankruptcy court for: (i) improperly drawing on the letter of credit, and (ii) retaining the letter of credit proceeds in excess of the amount of the section 506(b)(6) cap. The bankruptcy court held in favor of the trustee and entered a judgment against the landlord for damages in the amount of the letter of credit proceeds retained in excess of the capped claim.

The Fifth Circuit reversed the bankruptcy court and held instead that the 506(b)(6) claim limitation was not actually invoked because the landlord did not file a proof of claim in the case. Strictly reading the terms of the statute, the court found that section 506(b)(6) only applies if the landlord makes a claim against the estate. Because the landlord never asserted such a claim, it was therefore entitled to retain the full amount of the letter of credit proceeds notwithstanding the fact that the draw exceeded the landlord's damages as capped by section 506(b)(6).

Notably, even though it relied on the landlord's failure to file a proof of claim to reach its decision, the Fifth Circuit also found "problematic" the notion that section 502(b)(6) can be used to affirmatively recover proceeds from a lessor that has a security deposit which is greater than the amount allowed under the 502(b)(6) cap. The court was troubled by the trustee's attempt to convert the cap into an affirmative recovery

power separate and apart from the usual avoidance and recovery sections of the Bankruptcy Code (*i.e.*, sections 547, 548, 549, 550 and 553 which allow, among other things, a debtor's estate to affirmatively recover property from non-debtor third parties in instances when that property was obtained as a result of a preferential transfer to one creditor at the expense of others or as a result of a fraudulent conveyance).

WHAT THESE CASES MEAN TO LESSORS AND LESSEES OF REAL PROPERTY

Despite being addressed in three different judicial circuits, the full implications of a letter of credit on the section 502(b)(6) claims limitation has not been fully resolved. Because each court employed a predominantly fact-based analysis, the decisions did not explore policy justifications for their respective rulings or establish a unifying principle. Until a decision sets forth a bright-line rule, lessors and lessees will have to take into account the jurisdiction in which they find themselves and the primary factors articulated in these three cases when evaluating the effect a letter of credit may have on a landlord's rejection claim against the estate. These factors include:

1. *Whether a Proof of Claim Is Filed*

The *Stonebridge* court held that section 502(b)(6) only applies to claims filed against the debtor, therefore the decision not to file a proof of claim for lease rejection damages effectively makes section 502(b)(6) irrelevant. Thus, if the landlord holds cash security and/or a letter of credit payable on the lessee's breach in an amount greater than the landlord's rejection damage claim as capped by section 502(b)(6), the prudent landlord will forego asserting a claim in the lessee's bankruptcy case. This stratagem, however, may no longer work after *Stonebridge*. Section 501(c) and Bankruptcy Rule 3004 gives the debtor or trustee of the estate the authority to file a proof of claim on behalf of a creditor that did not file a claim. In light of the *Stonebridge* ruling, careful debtor-lessees and trustees will likely file protective proofs of claim on behalf of landlords of rejected leases in order to preserve for the estate the value of any security over and above the section 502(b)(6) cap. The filing of the lease rejection claim on behalf of the lessor will implicate the section 502(b)(6) limitation and may limit the landlord's entitlement to the proceeds of a letter of credit in excess of the 502(b)(6) cap. *Stonebridge* may still prove important, however, as the court's concerns about limiting the ability of a debtor to use section 502(b)(6) as a way to affirmatively recover from a landlord the proceeds from a letter of credit which are over and above the 502(b)(6) cap amount are likely to prove relevant even if a proof of claim is filed on behalf of the landlord by the debtor-lessee or trustee.

2. *Assets Pledged as Security for the Letter of Credit*

There seems to be at least one common thread between the Third and Ninth Circuits — if the lessee has pledged an equivalent amount of cash or other assets to secure its reimbursement obligation to the issuing bank, the court is likely to apply the letter of credit proceeds against the

rejection claim as capped by section 502(b)(6). Since the drawdown serves to indirectly deprive other creditors of recovery in the same manner as a cash security deposit, the courts are likely to apply the proceeds to the capped claim. The practical effect of the drawdown on the letter of credit will be recognized and likely given force by the courts in these jurisdictions and in jurisdictions that choose to follow their reasoning.

3. *Express Language of the Lease*

Finally, in the Third Circuit and likely in the Ninth Circuit, the court will look at the express terms of the lease when determining if the letter of credit is essentially a security deposit and thus subject to the 502(b)(6) cap. As noted above, in *PPI Enterprises*, the language of the lease explicitly referred to the letter of credit as a “security deposit” and the court used that terminology to reach its decision. Express language that gives the court insight into the intent of the parties can carry significant weight to a court that is addressing the issue when there is no bright-line rule with respect to letters of credit and the 502(b)(6) cap.

While none of these factors are decisive, they do provide some guidance for lessors and lessees when examining a lease or evaluating the treatment the proceeds of a letter of credit will receive in bankruptcy. Until an explicit rule is created by either Congress or the Supreme Court, lessors and lessees will have to carefully weigh the factors outlined above when negotiating and entering into real property leases that include letters of credit as credit support.