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Navigating a Tenant's Bankruptcy: Tips and Observations

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Recently, two significant distressed companies with thousands of commercial leases, Rite Aid and WeWork, each filed chapter 11 bankruptcy cases, seeking in part to rationalize their geographic footprints through the rejection of a substantial portion of their lease portfolios. Against this backdrop, and a potential trend of tenants using the bankruptcy process to exit leases that do not contribute to their profitability, we offer a brief refresher on some key issues, including (i) the consequences of lease "rejection," and (ii) the statutory cap on landlord damage claims for a rejected lease.

1. **Rejection Power.**

A tenant that files a chapter 11 bankruptcy case has the power to "reject" an unexpired commercial real property lease. "Rejection" is considered a material breach of the tenant's lease obligations and is a powerful tool for a debtor to shed its burdensome liabilities. As a result of lease rejection, a landlord's only recourse is to assert a claim for damages for breach (a "rejection damages claim"). In the absence of a security deposit, letter of credit or other collateral securing the tenant's obligations, the rejection damages claim is a general unsecured claim. General unsecured claims are paid after payment in full of secured claims, post-petition administrative expenses and priority unsecured claims. As a consequence, recovery on account of general unsecured claims depends entirely on the value of the debtor's assets to satisfy senior ranking obligations. In many cases, general unsecured claims get wiped-out.

2. **Damages Cap.**

When a lease is rejected, section 502(b)(6) of the Bankruptcy Code caps a landlord's damages claims at the greater of rent due for (i) one year or (ii) 15 percent of the remaining term (not to exceed three years). Separate from the rejection damages claim, landlords are also entitled to a claim for any unpaid rent due before the bankruptcy filing or date of repossession/surrender.

Three primary issues may arise when applying the Bankruptcy Code's rejection damages cap. First, while the one-year calculation is easily determined, the Bankruptcy Code is unclear as to whether the reference to "15 percent" applies to (a) the 15% remaining rent for the balance of the lease term (the "*Rent Approach*") or (b) 100% of the rent for 15% of the remaining term of the lease (the "*Time Approach*"). Second, courts are split on what types of claims are capped. For example, is a tenant's breach of its repair and maintenance obligations subject to the cap following rejection? Would the cap apply to damages claims against a non-debtor guarantor? And third, under circumstances where a landlord is holding a cash security deposit from the tenant or a letter of credit, whether application of the security deposit or draw on the letter of credit is also subject to the rejection damages cap. We address these points below.

A. **Rent Approach vs. Time Approach**

Whether the Bankruptcy Code's damages cap reference to "15 percent" is measured against the remaining rent or the remaining term on the lease can have significant consequences. The Rent Approach imposes a cap based on all rent under the remaining term of the lease (up to three years' rent). The Time Approach imposes a cap based on the first 15 percent of the remaining term of the lease (up to three years). For example, assume a lease provides the following annual rent for a remaining 10-year term:

- Years 1-5: $100,000 per year ($500,000 total)
- Years 6-10: $150,000 per year ($750,000 total)

The Rent Approach would cap termination damages at $187,000 (15% of $1,250,000 of rent over the remaining 10-year term). The Time Approach would cap termination damages at $150,000 (15% of the 10-year term is 1.5 years; rent coming due for the next 1.5 years of the remaining lease term is $150,000).

Accordingly, if the lease calls for rent increases during the term of the lease (as is common in many leases), the Rent Approach favors the landlord in maximizing its claim.

Courts are not uniform in their approach and no U.S. Court of Appeals has ruled on the issue. The Rent Approach is the majority view,[1] having been adopted in jurisdictions such as the Southern District of New York[2] and the District of New Jersey.[3] The District of Delaware, on the other hand, has adopted the Time Approach.[4]

Recently, the Bankruptcy Court for the Southern District of New York departed from its existing Rent Approach, applying the Time Approach in *In re Cortlandt Liquidating LLC*.[5] The bankruptcy court reasoned that, given other courts' shift away from the Rent Approach and the language of section 502(b)(6) being "worded in terms of periods of time," the Time Approach was the better interpretation of the section.

It remains to be seen whether the trend towards the Time Approach will continue.

B. **Types of Claims Subject to the Cap**

While section 502(b)(6)'s cap is applicable only to "damages resulting from the termination of a lease of real property," a landlord's claim may include amounts unrelated to the termination of the lease — and, therefore, not be subject to section 502(b)(6)'s cap. For example, unpaid rent owing under the lease before termination is not subject to the cap.

The Ninth Circuit and Bankruptcy Appellate Panel for the Eighth Circuit[6] have adopted a simple test to determine whether a claim would be subject to section 502(b)(6)'s cap: whether the damages result from the rejection of the lease; if so, the cap applies. Stated another way, the cap does not apply if the claim would nonetheless exist were the debtor to assume the lease rather than reject it. Under this test, claimed damages for maintenance and repairs do not result from the termination of the lease and, therefore, are not subject to a cap.[7] Similarly, damages associated with a tenant's failure to discharge any mechanic's lien pursuant to the lease would also not be subject to a cap.[8]

Another issue that courts have considered is whether the damages cap applies to the damages claim against a guarantor of the tenant's obligations under the lease. Several courts have held that the damages cap only applies if the guarantor is also a debtor.[9] Most recently, in *In re Cortlandt Liquidating LLC*, debtor Century 21 had guaranteed the lease obligations of a certain non-debtor affiliate. The non-debtor tenant defaulted on its lease and vacated the premises. While the tenant was not in bankruptcy, the guarantor was a debtor. The bankruptcy court determined that section 502(b)(6)'s cap applies to claims of a landlord for damages where the debtor is a guarantor of the tenant's lease obligations but not itself the tenant.[10]

In contrast, a non-debtor guarantor's obligations generally are not subject to section 502(b)(6)'s cap and a landlord can seek its aggregate, uncapped guaranty claim against the non-debtor guarantor. *See In re Modern Textile, Inc.*, 900 F.2d 1184, 1191 (8th Cir. 1990) ("[T]he liability of a guarantor for a debtor's lease obligations is not altered by . . . rejection of the lease.").

C. **Security Deposits and Letters of Credit**

A security deposit or letter of credit often will not protect a landlord asserting a damages claim in excess of the statutory cap. Courts have held that, based on the legislative history of section 502(b)(6), a security deposit held by a landlord can be applied only to the capped claim, and any remaining deposit in excess of the damages cap must be returned to the debtor-tenant.[11]

Requiring a letter of credit in lieu of a cash security deposit does not improve a landlord's position. Letters of credit are obligations of the issuing bank, rather than the debtor in bankruptcy, and its proceeds are not part of the debtor-tenant's bankruptcy estate.[12] However, in the context of a lease transaction, a number of courts have applied section 502(b)(6)'s cap to a landlord's draw on a letter of credit. For example, in *In re PPI Enterprises (U.S.), Inc.*, the lease provided that a letter of credit could be provided in lieu of a cash security deposit. The Third Circuit affirmed the bankruptcy court's holding that the parties intended the letter of credit to serve as a security deposit.[13]

A letter of credit *may* still be a viable protection against application of section 502(b)(6)'s cap so long as the letter of credit does not serve to replace a security deposit. For example, lease language such as "a portion of the security deposit may be in the form of an irrevocable letter of credit" has been determined to constitute a security deposit subject to the cap.[14] To avoid the limitations of section 502(b)(6), landlords should ensure that the lease includes clear language that the parties acknowledge that any letter of credit is not intended to constitute a security deposit (*e.g.*, it could be drafted as a third-party guaranty of the obligations under the lease).

Additionally, the Fifth Circuit has held that if a landlord does not subject its claims to the debtor-tenant's bankruptcy by submitting a claim against the debtor-tenant's estate, then section 502(b)(6)'s cap does not prevent the landlord from drawing on a letter of credit.[15]

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Using the Bankruptcy Code to restructure a distressed company's lease portfolio is not a new trend, but, with the uptick in chapter 11 filings, we wanted to provide our clients with a refresher to highlight a few key nuances affecting the treatment of commercial leases in bankruptcy.

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[1] *In re Today's Woman*, 195 B.R. 506, 507-08 (Bankr. M.D. Fl. 1996); *In re Shane Co.*, 464 B.R. 32, 39 (Bankr. D. Colo. 2012)

[2] *In re Andover Togs, Inc.*, 231 B.R. 521, 547 (Bankr. S.D.N.Y. 1999).

[3] *In re New Valley Corp.*, 2000 U.S. Dist. LEXIS 12663, at *33-34 (D.N.J. Aug. 31, 2000). Courts in Texas also appear to endorse the Rent Approach. *In re Stonebridge Techs., Inc.*, 2003 Bankr. LEXIS 275, at *10 (Bankr. N.D. Tex. Mar. 3, 2003); *In re Perry*, 411 B.R. 368, 375 n.2 (Bankr. S.D. Tex. 2009).

[4] *In re Filene's Basement, LLC*, 2015 Bankr. LEXIS 1350 (Bankr. D. Del. Apr. 16, 2015).

[5] 648 B.R. 137 (Bankr. S.D.N.Y. 2023).

[6] *In re Kupfer*, 852 F.3d 853 (9th Cir. 2016); *In re Wigley*, 533 B.R. 267 (8th Cir. B.A.P. 2015). Other courts have moved away from an all-or-nothing approach (*see In re Foamex Int'l, Inc.*, 368 B.R. 383, 393-392 (Bankr. D. Del. 2007)) to apply the Ninth and Eighth Circuits' tests. *In re Cortlandt Liquidating LLC*, 648 B.R. 137, 144 (Bankr. S.D.N.Y. 2023).

[7] *In re El Toro Mats. Co.*, 504 F.3d 978 (9th Cir. 2007).

[8] *In re Cortlandt Liquidating LLC*, 648 B.R. at 145.

[9] *In re Arden*, 176 F.3d 1226 (9th Cir. 1999); *In re Episode USA, Inc.*, 202 B.R. 691, 695 (Bankr. S.D.N.Y. 1996) ("[t]he thrust of the § 502(b)(6) cap is not directed toward any particular debtor entity; rather, it acts to limit the amount of damages the lessor may be allowed from the bankruptcy estates" (internal quotations omitted)); *In re Ancona*, 2016 Bankr. LEXIS 636 (Bankr. S.D.N.Y. Mar. 2, 2016).

[10] *In re Cortlandt Liquidating LLC*, Case No. 20-12097 (Bankr. S.D.N.Y. May 20, 2022) (ECF No. 1260).

[11] *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 208 (3d Cir. 2003); *In re Atl. Container Corp.*, 133 B.R. 980 (Bankr. N.D. Ill. 1991) ("It is well-settled that a security deposit held by a lessor on a rejected lease must be applied against the maximum claim for lease termination damages allowed to the lessor under § 502(b)(6).").

[12] *S-Trans Holding, Inc. v. Protective Ins.*, 414 B.R. 28 (Bankr. D. Del. 2009); *In re Zenith Labs, Inc.*, 104 B.R. 667 (Bankr. N.J. 1989); *Kellogg v. Blue Quail Energy, Inc. (Matter of Compton Corp.)*, 831 F.2d 586, 589 (5th Cir. 1988).

[13] *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 210 (3d Cir. 2003).

[14] *In re Stonebridge Techs., Inc.*, 2003 Bankr. LEXIS 275 at *20 (Bankr. N.D. Tex. Mar. 3, 2003).

[15] *In re Stonebridge Techs., Inc.*, 430 F.3d 260, 269-70 (5th Cir. 2005).

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