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# commercial advisor

## Third Circuit Determines That Bankruptcy Filing by Commercial Tenant to Limit Damages Assertable by Landlord Not in Bad Faith

Dealing a significant blow to commercial landlords, and providing tenants with some leverage to get out of a bad long-term lease, the Third Circuit recently determined that the fact that a commercial tenant made a Chapter 11 filing solely for the purpose of taking advantage of the statutory damage cap imposed on landlord claims under 11 U.S.C. § 502(b)(6) in order to maximize the return to shareholders, was not a basis to dismiss the case as a bad faith filing. Furthermore, the court found that the operation of such statutory cap does not impair the landlord's claim for purposes of voting on a plan of reorganization. *Solow v. PPI Enterprises (U.S.), Inc., et al. (In re PPI Enterprises (U.S.), Inc. et al.),* 324 F.3d 197 (3d Cir. 2003)(*PPI Enterprises*).

Accordingly, the landlord, whose claim as capped was to be paid in full in cash, was determined to be an "unimpaired creditor" and was therefore deemed to have accepted the debtor's plan, despite having voted against such plan. Rubbing salt into the landlord's fresh wounds, the Third Circuit also found that a letter of credit issued as security for the affected lease should be treated like a cash security deposit and credited against the claim capped under § 502(b)(6), and that it could not be applied against the landlord's uncapped claim under otherwise applicable non-bankruptcy law.

### Background

The debtor, PPI Enterprises, leased 10,000 square feet of office space in a Manhattan office tower pursuant to a 10-year lease, for an annual rental payment of over $620,000. Sanwa Bank issued a letter of credit to the landlord in the amount of $650,000 as security for the debtor's lease obligations.

Subsequently, the debtor encountered financial difficulties, and in September 1991—about two years into the lease—abandoned the Manhattan premises and ceased paying rent. The landlord subsequently drew in full the Sanwa-issued letter of credit (applying such proceeds to monthly rental payments due from October 1991 through July 1992). The debtor filed for Chapter 11 protection.

In August 1996, the landlord filed a proof of claim in the debtor's case, alleging damages of $4.757 million (the gross amount of rent less a small amount of substitute rent and the letter of credit proceeds). In December 1996, the landlord moved to dismiss the debtor's bankruptcy filing for bad faith—alleging that the filing was a sham and was made for no legitimate purpose. The motion was denied in January 1997, without prejudice.

In March 1998, the debtor filed its reorganization plan, which treated the landlord's claim as a Class 2 general unsecured claim.

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Although the debtor solicited votes from, among others, the Class 2 claimholders, it contended that Class 2 claimholders were not impaired and their approval was not necessary. Ultimately, the landlord and the only other Class 2 creditor returned their ballots—the landlord voting against the plan and the other creditor voting in favor. The landlord renewed its motion to dismiss and asserted objections to confirmation of the plan, contending that since the majority of Class 2 had not voted to accept the plan, the class should be deemed to have rejected the plan, meaning that the plan could not be confirmed. In December 1998, the bankruptcy court determined that the landlord's claim was subject to the statutory cap under § 502(b)(6) and was reduced by the amount of the letter of credit. The court also found that the bankruptcy was filed in good faith and that the landlord was an "unimpaired creditor" and was therefore deemed to have accepted the plan. The decision was appealed, and was affirmed by the United States District Court for the District of Delaware, without opinion.

### The Third Circuit's Ruling

On appeal, the Third Circuit addressed several issues: (i) whether the landlord's claim was "unimpaired," thereby precluding the landlord from voting on the debtor's plan, (ii) whether the bankruptcy filing was made by the debtor in bad faith, and (iii) whether the proceeds of the letter of credit should be applied to the statutory damage cap under § 502(b)(6). In affirming the district court, the Third Circuit resolved each of these issues in favor of the debtor-tenant.

#### *A. The Statutory Cap Under § 502(b)(6) Did Not Impair the Landlord's Damages Claim*

The central issue on appeal was whether the landlord's claim was impaired by operation of the statutory damages cap under § 502(b)(6), which limits a landlord's claim to the rent reserved under the lease for the greater of (i) one year, or (ii) fifteen percent, not to exceed three years, of the remaining lease term. 11 U.S.C. § 502(b)(6). If the claim were impaired, the landlord would be entitled to vote on the plan; otherwise, it would be deemed to have accepted the plan. While the Bankruptcy Code creates a presumption of impairment to maximize the ability of creditors to participate in the reorganization process, such presumption is overcome if the plan "leaves unaltered the [creditor's] legal, equitable and contractual rights." 11 U.S.C. § 1124(1). The burden is on the debtor to demonstrate that a creditor's claim is unaltered by the plan and therefore not impaired.

In reaching the conclusion that the landlord's claim was *not* impaired for purposes of § 1124 and voting on the plan, the Third Circuit relied heavily on the distinction that the limitation on the landlord's claim was dictated by § 502(b)(6) and not by the terms of the plan. In reaching its conclusion, the Third Circuit agreed with the analysis in *In re American Solar King Corp.*, 90 B.R. 808 (Bankr. W.D.Tex. 1988), where, in the context of evaluating the operation of § 510(b) in altering a creditor's claim, the court found that because § 510(b)—like, in this case, § 502(b)(6)—is a statute which defines a person's legal rights, any alteration of such rights is a consequence of the bankruptcy filing itself and not of the plan. *Id.* at 819-20.

Taking the *Solar King* decision a step further, the Third Circuit found that, under § 1124(1), "a creditor's claim outside of bankruptcy is not the relevant barometer for impairment; [the court] must examine whether the plan itself is a source of limitation on the creditor's legal, equitable, or contractual rights." The Third Circuit was clear that the plan intended to pay the landlord its "legal entitlement"—however, the landlord was only entitled to the amount of its claim after application of the § 502(b)(6) cap. Therefore, the Third Circuit found that the

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application of § 502(b)(6) did not impair the landlord's claim for voting purposes and that whether the landlord could, outside of bankruptcy, have recovered more on its claim became irrelevant once the debtor filed for protection under Chapter 11.

***B. Filing to Avail Debtor of Bankruptcy Code Provisions Was Not Bad Faith Filing***

The landlord had also moved, under § 1112 of the Bankruptcy Code, to dismiss the debtor's bankruptcy filing—which was made principally to avail the debtor of the statutory damage cap under § 502(b)(6)—claiming that the filing was made in bad faith. The court noted that the bankruptcy court had conducted four days of evidentiary hearings and made specific factual findings—including that the primary purpose of the filing was to cap the landlord's claim. The court concluded that it is not in bad faith to commence a case to take advantage of a particularly favorable provision of the Bankruptcy Code, even where, as here, the result of the landlord's claim being capped was to enhance the value to be realized by the debtor's shareholders.

***C. Third Circuit Holds That a Letter of Credit, like a Cash Security Deposit, Should Be Applied to Reduce Capped Damages Rather Than Offset Against Full Non-Bankruptcy Claim***

The Third Circuit also held that the proceeds of the Sanwa-issued letter of credit should be applied to reduce the landlord's damages as limited by § 502(b)(6), rather than be applied against the amount of the claim determined under non-bankruptcy law. *See* H.R. REP. NO. 95-595, at 354 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6310 ("[A landlord] will not be permitted to offset his actual damages against the security deposit and then claim for the balance under [§ 502(b)(6)]. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under [the statute].").

The landlord had argued that there was a fundamental difference between a letter of credit and a cash security deposit—the letter of credit is a third-party obligation and the cash security deposit is property of the debtor. The Third Circuit noted that, although such distinction is important, if the landlord were entitled to keep the proceeds of the letter of credit, Sanwa would have a reimbursement claim against the debtor for such amount and the landlord would still be able to collect its full capped claim against the debtor—thus, in part, circumventing the application of the damages cap under § 502(b)(6), to the debtor's detriment. Ultimately, the Third Circuit decided the issue by examining the language of the lease itself, which made it clear that the letter of credit had been provided "in lieu of" the cash security deposit otherwise required under the lease. Furthermore, the lease required the letter of credit to be replenished if drawn upon by the landlord. Therefore, the court found that the letter of credit was intended by the parties to serve as a security deposit, and affirmed the bankruptcy court decision to apply the proceeds thereof against the capped damages claim.

## Bankruptcy Court Holds That Proceeds of Letter of Credit in Excess of Capped Lease Rejection Damages May Not Be Retained by Landlord

In another decision addressing the relationship between letters of credit and real estate lease security deposits, the United States Bankruptcy Court for the Northern District of Texas held in *In re Stonebridge Technologies, Inc.*, 291 BR 63 (Bankr. N.D. Tex. 2003), that—to the extent that the proceeds from a letter of credit exceeded the capped amount of the landlord's claim under § 502(b)(6) of the Bankruptcy Code—the landlord could not retain such excess amount.

If the landlord were entitled to keep the proceeds of the letter of credit, the landlord would, in part, circumvent the application of the damages cap under §502(b)(6), to the debtor's detriment.

Similar to the decision in *PPI Enterprises*, the lease in *Stonebridge* provided that the "security deposit" for the lease included both a cash component and the letter of credit. In reaching its decision, the bankruptcy court relied on this fact and the legislative history of § 502(b)(6), which provides that any "security deposit" will be applied in satisfaction of the claim that is allowed under § 502(b)(6) and may not be applied against the landlord's actual damages.

The bankruptcy court further justified its decision by claiming that the application of the letter of credit proceeds was consistent with the "independence principle" applicable to letters of credit—that the issuer's obligations to the beneficiary are independent from any obligation between the beneficiary and the issuer's customer (in this case, the tenant). The court followed the reasoning of the other courts that the independence principle protects only the distribution of the proceeds of letters of credit and does not address claims respecting the underlying contract or lease. Notwithstanding the fact that the landlord received all of the proceeds of the letter of credit, the court found that the lease and applicable bankruptcy law, namely § 502(b)(6), controlled what the landlord could do with those proceeds, and therefore the landlord could not retain any proceeds in excess of its capped claim.

## Summary

The *PPI Enterprises* and *Stonebridge* decisions provide commercial tenants with new and improved leverage to negotiate the termination of a long-term lease, particularly where a debtor is otherwise current with its creditors. Now there is precedent for a tenant to threaten—and actually file and confirm—a plan that "crams down" on a recalcitrant landlord, even if it is clear and obvious that the sole purpose of the Chapter 11 filing is to force the landlord to accept a lesser amount in satisfaction of its claim, and even if the debtor—taking advantage of the statutory cap—is only seeking to maximize the return to its shareholders. Similarly, while a letter of credit continues to function well as credit enhancement, the recent trend is that a letter of credit will not allow a landlord to avoid the statutory limitation on the amount a landlord can claim in a bankruptcy case. Nonetheless, through proper structuring and drafting of leases, landlords can maximize their prospects for favorable treatment of letters of credit.

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