

Filing Bankruptcy by Solvent Tenants to Cap Landlords' Claims

BANKRUPTCY CODE SECTION 502(b)(6) provides a cap on claims of landlords for damages under long-term real property leases. Businesses such as retail chain stores often file reorganization cases under chapter 11 of the Bankruptcy Code in order to take advantage of this cap when closing unprofitable locations. These cases generally involve insolvent entities that are facing many difficult financial issues and challenges.

Courts recently have addressed whether a solvent entity may commence a chapter 11 reorganization solely to reject its one and only real estate lease and limit its landlord's lease termination damages claim. While courts uniformly recognize that chapter 11 is available to solvent entities, in two recent decisions—*In re Integrated Telecom Express, Inc.*¹ and *In re Liberate Technologies*²—the use of chapter 11 by solvent entities solely to apply the Section 502(b)(6) cap was limited to situations in which the debtor was facing some level of financial distress.

The Section 502(b)(6) cap is designed to limit lease termination claims to prevent landlords from receiving a windfall at the expense of other creditors. Depending upon the length of a lease, the landlord's claim for future rent could be enormous and dramatically diminish the return to other unsecured creditors.³ Section 502(b)(6) limits the claim of a lessor for damages resulting from the termination of a lease of real property to:

- (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.

The Section 502(b)(6) cap should be a relatively simple calculation. First, the court calculates the total rent reserved⁴ under the lease from the earlier of the date of the tenant's bankruptcy filing or the date on which the landlord repossessed or the lessee surrendered the leased property. Second, the court calculates 15 percent of the total due under the lease. Third, the court compares this 15 percent amount to the rent reserved under the lease for one year following the earlier of the bankruptcy filing or repossession or surrender of the leased property. The cap is the greater of the two, subject to the 15 percent amount not exceeding the amount of three years of rent. For example, in a scenario in which the debtor is current on all lease payments and has five years remaining, and the rent reserved under the lease is \$100,000 per month, the total amount of future rent is \$6 million, of which 15 percent is \$900,000. The rent reserved for one year is \$1.2 million, so the cap is \$1.2 million. If instead of five years there are 10 years remaining under the same lease, the total amount of future rent is \$12 mil-

lion, and 15 percent of this amount is \$1.8 million. Since the 15 percent amount is greater than the amount of rent reserved for one year and is less than rent for three years, the landlord's claim would be capped at \$1.8 million.

Solvent Chapter 11 Filings

There is no question that insolvent entities may file bankruptcy to take advantage of this cap. However, access to bankruptcy protection is not conditioned on insolvency.⁵ A debtor does not have to demonstrate insolvency under either a balance sheet test (liabilities in excess

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of assets) or under a liquidity test (unable to pay its debts as they come due).⁶ While the Bankruptcy Code does not limit chapter 11 relief to insolvent debtors or those who suffer any particular form of financial distress, courts have held that this “does not mean that all solvent firms should have unfettered access to Chapter 11.”⁷

The lack of any bankruptcy solvency test is rooted in the reality that, at times, solvent entities suffer from financial distress.⁸ In fact, “[i]t is not uncommon for debtors to be solvent under the balance sheet test, and yet to have severe financial problems.”⁹ Congress rightfully believed that entities should be eligible for relief under chapter 11 before becoming insolvent under a balance sheet test: “The prospects for reorganizing a debtor in financial difficulty are much better when the debtor is still solvent than after it becomes insolvent.”¹⁰ Accordingly, the absence of an insolvency requirement allows entities to enter chapter 11 before facing a financially hopeless situation.

Nevertheless, to safeguard the integrity of the purpose of chapter 11, courts have created a good faith doctrine.¹¹ If a chapter 11 bankruptcy petition is not filed in good faith, a bankruptcy court may dismiss the petition “for cause” or convert the chapter 11 case to a chapter 7 liquidation case pursuant to Bankruptcy Code Section 1112(b).¹² The good faith determination is made on a case-by-case basis that focuses on the totality of the circumstances and involves a fact-intensive inquiry.¹³

In examining the question of good faith, courts generally address two primary areas: 1) whether the bankruptcy petition serves a legit-

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imate bankruptcy purpose, such as preserving a going concern (along with employees' jobs) by avoiding the piecemeal liquidation of the enterprise or otherwise maximizing the value of the debtor's estate, and 2) whether the petition was filed simply to create delay, harass or impose hardship on creditors, or otherwise obtain a tactical advantage in litigation.¹⁴ The Third Circuit Court of Appeals has explained the development of the judicially created good faith requirement:

It is easy to see why courts have required Chapter 11 petitioners to act within the scope of the bankruptcy laws to further a valid reorganizational purpose. Chapter 11 vests petitioners with considerable power—the automatic stay, the exclusive right to propose a reorganization plan, the discharge of debts, etc.—that can impose significant hardship on particular creditors. When financially troubled petitioners seek a chance to remain in business, the exercise of those powers is justified. But this is not so when a petitioner's aims lie outside those of the Bankruptcy Code.¹⁵

The majority of chapter 11 debtors are insolvent and, in those cases, the good faith doctrine is generally not implicated. In contrast, when the debtor is solvent and files a chapter 11 petition in order to use Section 502(b)(6) to cap its sole landlord's claim, thereby enhancing the recovery of the debtor's shareholders (as opposed to its creditors), courts have struggled with the application of the good faith doctrine. In chapter 11 cases involving multiple leases, the issue is less likely to arise since these cases will involve more than just a two-party dispute, and there is a greater likelihood of more complicated financial issues and problems.

Recent Case Law

Prior to 2004, courts examining whether the commencement of a bankruptcy case for the purpose of using a particular provision in the Bankruptcy Code constituted bad faith found that, absent other factors, it did not.¹⁶ Against that backdrop, it is important to understand the reasoning of *Integrated Telecom Express*¹⁷ and *Liberate Technologies*,¹⁸ in which the Third Circuit Court of Appeals and a Northern District of California bankruptcy court, respectively, held that filing chapter 11 solely to use Section 502(b)(6) to cap a single landlord's lease termination damage claim does not, by itself, establish good faith.

In *Integrated Telecom Express*, the Third Circuit addressed a situation in which "a Chapter 11 petition [was] filed by a financially healthy debtor, with no intention of reorganizing or liquidating as a going concern, with no reasonable expectation that Chapter 11

proceedings will maximize the value of the debtor's estate for creditors, and solely to take advantage of a provision in the Bankruptcy Code that limits claims on long-term leases...."¹⁹ The debtor had \$105.4 million in cash and \$1.5 million in other assets at the time it filed its chapter 11 petition. The landlord asserted a claim of approximately \$26 million. The debtor listed other miscellaneous liabilities of approximately \$430,000 and had exposure in connection with a class action lawsuit of up to \$5 million (any liability in excess of that amount was covered by insurance). Thus, the debtor was not suffering financial distress and was highly solvent and cash rich at the time it filed a chapter 11 petition. Applying the Section 502(b)(6) cap, the landlord's claim would be reduced from \$26 million to \$4.3 million, and the shareholders of the debtor would enjoy the benefit of this reduction. In addition, the case involved a smoking gun—a board resolution and letter of counsel composed prior to the bankruptcy filing stating that, if the landlord was unwilling to settle, the debtor would file a chapter 11 petition and cap the landlord's claim under Section 502(b)(6).

The Third Circuit found that the chapter 11 petition was not filed in good faith since the debtor was not in financial distress, and the filing would not preserve any value for the debtor's creditors that would have been lost absent the filing. According to the appeals court:

To be filed in good faith, a petitioner must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost—not merely distributed to a different stakeholder—outside of bankruptcy. This threshold inquiry is particularly sensitive where, as here, the petition seeks to distribute value directly from a creditor to a company's shareholders.²⁰

The Third Circuit determined that the question of good faith was antecedent to the application of Section 502(b)(6), stating: "§502(b)(6) and the legislative policy underlying that provision assume the existence of a valid bankruptcy, which, in turn, assumes a debtor in financial distress."²¹ Finding that the petition was not filed in good faith, the Third Circuit dismissed it.

The Third Circuit distinguished *Integrated Telecom Express* from its earlier decision in *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*²² and from the Ninth Circuit's decision in *Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)*²³ on the grounds that the debtors in those cases were in financial distress and may actually have been insolvent. In *PPI*, the debtor

claimed to have been insolvent, although this depended on whether claims of insiders were allowed. The Third Circuit in *PPI* held that a chapter 11 petition and liquidating chapter 11 plan filed for the primary purpose of capping a landlord's lease termination damages claim did not contravene the good faith requirement. In its *Integrated Telecom Express* decision, the Third Circuit stated that "*PPI* stands for the proposition that an insolvent debtor can file chapter 11 in order to maximize the value of its sole asset to satisfy its creditors while at the same time availing itself of the landlord cap under §502(b)(6)."²⁴

Also, in *Integrated Telecom Express* the Third Circuit distinguished *Sylmar Plaza* as a case in which solvency was at issue and chapter 11 was used to maximize value for creditors. The appeals court stated that "although the debtors appear to have come out solvent in *Sylmar Plaza*, there is no indication that they would have come out solvent had the bank's claim not been limited, or that solvency was a foregone conclusion when the petition was filed."²⁵

Although *Sylmar Plaza* did not involve Section 502(b)(6), the Ninth Circuit in that case addressed a plan in which the sole purpose was to enable the debtors to "cure and reinstate" an obligation under Bankruptcy Code Section 1124(2). In so doing, the debtor avoided an approximately \$1 million contractual liability for default interest owed to the debtor's secured creditor bank. The Ninth Circuit rejected the bank's argument that a chapter 11 plan lacked good faith when it left the debtors solvent while allowing them to reverse and avoid paying default interest to the bank, stating that "[g]iven the specific power to cure defaults, it makes no sense to treat a plan invoking that power as lacking good faith."²⁶

The Northern District bankruptcy court's finding in *Liberate Technologies*²⁷ that filing bankruptcy solely to use Section 502(b)(6) did not constitute the requisite good faith emerged from a situation in which the debtor had ongoing business operations that were suffering significant losses and faced several pending lawsuits. However, the debtor had \$212 million of unrestricted cash on hand and had total liabilities between approximately \$59 million and \$167 million, depending upon the outcome of the pending litigation. Accordingly, the debtor's cash exceeded its liabilities by between \$45 million and \$153 million. Further, the debtor had received an offer from an entity willing to purchase the debtor's business assets without a bankruptcy filing.

Facing a motion to dismiss the chapter 11 petition as a bad faith filing, the debtor asserted that it needed bankruptcy relief because of pending litigation, operational

losses, its desire to cap its landlord's lease termination damage claim, and problems in selling its assets. The bankruptcy court rejected each of these reasons. The court found that the pending litigation did not create a present need for bankruptcy relief because 1) it did not threaten the continuation of the debtor's business, 2) the debtor might never incur significant liabilities from the lawsuits, and 3) the debtor could pay any judgments without liquidating business assets. The court further found that the debtor's lack of profitability and the prospect of further losses did not show a present need for bankruptcy relief when the debtor had the present ability to pay all its debts without liquidating business assets. Moreover, the debtor's own evidence showed that the debtor did not need chapter 11 protection to effect a sale of its assets as a going concern, according to the court. Also, the court noted that allowing the chapter 11 case to proceed would impose real hardship on the debtor's landlord since the debtor sought to reduce the amount of the landlord's claim from \$45 million due under state law to the capped sum of \$8 million allowed under Section 502(b)(6). In dismissing the chapter 11 case, the court found that the debtor's proposed use of Section 502(b)(6) was simply a neutral factor that did not establish either good faith or bad faith.

Chameleon Systems and Chapter 7

By contrast, in *In re Chameleon Systems, Inc.*,²⁸ an earlier decision, another Northern District bankruptcy court held that a solvent debtor could use chapter 11 to cap lease damages. The debtor in that case filed its chapter 11 petition for the purpose of rejecting its sole real estate lease and then capping the landlord's lease termination damage claim under Section 502(b)(6). The debtor had no ongoing operations, no income, and no employees other than a consultant it had hired to wind down its affairs, liquidate its assets, and settle various obligations owed to creditors. The debtor had in excess of \$4 million in its bank accounts and, other than its \$4 million-plus obligation to its landlord, the debtor's total outstanding obligations amounted to approximately \$25,000. Unlike *Integrated Telecom Express* and *Liberate Technologies*, the debtor would have been insolvent if the landlord's claim was not capped. However, if the Section 502(b)(6) cap were to be applied, the debtor would have cash substantially in excess of the amount of its debt.

Prior to filing its chapter 11 petition, the debtor attempted to surrender possession of the premises to the landlord and to negotiate a termination of the lease, but the parties were not able to reach an agreement. There

were approximately three years remaining before the lease would expire, and the debtor did not want to continue paying the landlord the monthly rent through the expiration date despite the fact that it had adequate funds to do so. In its decision, the bankruptcy court summarized applicable California landlord-tenant law:

Under California law...[the landlord] had the option of accepting the surrender of the property and then having the state court fix the damages for the breach of the lease. This would have adjudicated the total damages suffered by...[the landlord] as a result of the breach of the lease. Rather than pursue this course of action...[the landlord] elected its other option, to continue to consider...[the debtor] its tenant and to seek to collect rent on a monthly basis...[for approximately another three years].²⁹

After filing its chapter 11 petition, the debtor filed a motion seeking to reject the lease and cap the landlord's claim at \$1.816 million. The landlord responded by filing a motion requesting that the bankruptcy court dismiss the case as a bad faith filing. While recognizing that reorganization of an ongoing business or the liquidation of assets are valid purposes for filing chapter 11, the *Chameleon Systems* court noted that, in this case, there was no ongoing business, and the liquidation of assets had been completed prior to the filing of the chapter 11 petition. The court focused on whether the debtor's filing was a legitimate use of the Bankruptcy Code or whether the debtor was attempting to unreasonably deter and harass creditors simply as a litigation tactic.³⁰ The court acknowledged that:

[T]he resolution of this dispute involves a possible windfall no matter what the decision. If the court decides in favor of the debtor and allows the bankruptcy to continue the claim will be capped and it appears that additional funds will flow to shareholders of the debtor. On the other hand if the case proceeds under California law, the debtor is presented with a Hobson's choice. Chameleon must stay in existence for another two or three years, or pay...[the landlord] now whatever it demands to terminate the lease regardless of what might happen in terms of mitigation later in 2004, 2005 or 2006. In the latter case, if the property is rented in the next 2 years for any amount the landlord will receive a windfall and the debtor will not be in existence to complain. Either way there is the possibility of a windfall.³¹ Ultimately, the court found that if the case

had been filed under chapter 7 of the Bankruptcy Code, the landlord's claim would be capped—because bad faith does not constitute cause to dismiss a chapter 7 case—and the fact that the debtor was solvent and filed under chapter 11 should not change that result.

Chameleon Systems suggests that, when a debtor is liquidating its assets, a potential means for completely avoiding the good faith issue would be for the debtor to file under chapter 7 instead of chapter 11. Section 502(b) is not tethered to chapter 11. It applies equally to chapter 7 cases. The problem, however, is that entities other than individuals do not receive a discharge in chapter 7 or liquidating chapter 11 cases.³² Moreover, according to one bankruptcy court and echoed by others, "the Bankruptcy Code simply does not contemplate that equity security holders will share in the distribution of the estate in cases under Chapter 7—any surplus is to be distributed to the debtor."³³

In *Liberate Technologies*, the court explained that "Section 502(b)(6) limits distributions in the bankruptcy case; it does not preclude enforcement of the liability outside of bankruptcy where there is no discharge."³⁴ As a result, in a case in which the debtor does not obtain a discharge, capping a landlord's claim in the bankruptcy estate under Section 502(b)(6) may not prevent the landlord, after all creditors have been paid in full, from seeking its share of surplus funds returned to the debtor. This result might be avoided, even in a liquidating chapter 11 case, if the debtor sufficiently continues in business under its plan in order to obtain a discharge.³⁵

Another problem with the chapter 7 approach is that, unlike chapter 11, an independent trustee is automatically appointed to marshal and distribute the debtor's assets, and this may not appeal to the board of directors of a debtor of questionable solvency if millions of dollars of cash remain on hand. However, chapter 7 is an option that should influence the negotiations between the parties. A better understanding of the alternatives might even help the parties avoid any sort of excursion into bankruptcy jurisdiction.

The common thread that runs through the case law is that the question of good faith is based on the totality of the circumstances. This requires a fact-intensive inquiry on a case-by-case basis. In situations in which 1) a petition is filed solely as a litigation tactic in a two-party dispute or 2) the sole intent of a solvent debtor that is not suffering from financial distress is to avail itself of the Section 502(b)(6) cap, the recent decisions suggest that the court may find the requisite good faith lacking. Accordingly, counsel should advise debtors to find other bona fide reasons for filing a chapter 11 petition and to continue to

