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Claims Chat

By Tad Davidson and Philip Guffy

Commercial Lease Rejection in Full-Pay Cases

Tad Davidson
Hunton Andrews Kurth LLP; Houston

Philip Guffy
Hunton Andrews Kurth LLP; Houston

Tad Davidson is a partner with Hunton Andrews Kurth LLP in Houston and co-leader of the firm's national Bankruptcy and Restructuring Practice Group. Philip Guffy is an associate in the same office.

In prepackaged and pre-negotiated large chapter 11 cases, debtors will sometimes propose a "full-pay" plan that leaves general unsecured creditors unimpaired. Doing so often allows for expedited plan confirmation, particularly when the impaired classes have already approved the plan or have committed to doing so. Having a claim "unimpaired," however, does not mean that one is going to get paid everything one would have gotten outside of bankruptcy. Several courts have held that a claim can still be unimpaired, even if it is not being paid in the full amount that it would have been paid outside of bankruptcy, as long as it is the Bankruptcy Code itself doing "impairment," and not the plan.[1]

In particular, § 502(b)(6) caps the amount of claims of commercial landlords as a result of rejection of their leases. Thus, a plan can treat such claims as unimpaired if the claims are being paid the capped amount, even if the landlord is not getting the full amount it would be entitled to for a breach of the lease outside of bankruptcy. While landlords can use traditional credit supports (guaranties, letters of credit, etc.) to enhance their recoveries, such credit support may be subject to the same caps. Thus, even when proposing a "full-pay" plan, debtors can still use the Bankruptcy Code to shed burdensome leases at a discount, and landlords should be aware that "unimpaired" is not the same thing as "paid in full."

When a Claim Is Unimpaired

Section 1124 of the Bankruptcy Code specifies that a claim is unimpaired if "the plan ... leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest," or if the claim is in default, and the plan cures the default and reinstates the claim.[2] If a class of claims is unimpaired, the holders of those claims are presumed to have accepted the plan and are not entitled to vote, and the debtors do not have to solicit their votes.[3] This can be advantageous to debtors, as it saves on solicitation costs and simplifies the confirmation process.

However, a claim that is "unimpaired" under § 1124 will not necessarily be paid in the full amount that would otherwise be owed outside of bankruptcy, because § 1124 specifies that whether a claim is impaired depends on what the *plan* does to impair the claim.[4] As a result, "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 a creditor's legal, equitable, or contractual rights."[5] In particular, this means that any limitations imposed on a claim by the Bankruptcy Code will not affect whether the claim is considered to be impaired.

Thus, a plan that incorporates such limitations does not impair a claim as long as the claimant's other legal, equitable and contractual rights remain unaltered. This explicitly includes § 502(b)(6) of the Bankruptcy Code.[6] As a result, even under a full-pay plan, a landlord's claim arising from the rejection of its lease with the debtor will still be subject to the statutory cap under § 502(b)(6).

Section 502(b)(6)

Section 502(b)(6) "caps a landlord's claim in bankruptcy for damages resulting from the termi-

1 *Keystone Gas Gathering LLC v. Ad Hoc Comm. of Unsecured Creditors of Ultra Res. Inc. (In re Ultra Petroleum Corp.)*, 943 F.3d 758, 763 (5th Cir. 2019); *Solow v. PPI Enters. (U.S.) Inc. (In re PPI Enters. (U.S.) Inc.)*, 324 F.3d 197, 204 (3d Cir. 2003).
2 11 U.S.C. § 1124.
3 11 U.S.C. § 1126(f).
4 11 U.S.C. § 1124.
5 *PPI Enters.*, 324 F.3d at 204; *see also Ultra Petroleum*, 943 F.3d at 763 ("The plain text of § 1124(1) requires that 'the plan' do the altering.").
6 *PPI Enters.*, 324 F.3d at 204 ("Accordingly, we hold that where § 502(b)(6) alters a creditor's nonbankruptcy claim, there is no alteration of the claimant's legal, equitable, and contractual rights for the purposes of impairment under § 1124(1).").

nation of a real property lease."[7] The purpose of this cap is to strike a balance between compensating the landlord for damages "while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate."[8] Section 502(b)(6) disallows any portion of a landlord's claim that exceeds the "rent reserved from the greater of (1) one lease year or (2) fifteen percent, not to exceed three years, of the remaining lease term."[9]

"Rent reserved" is not defined under the Bankruptcy Code, but several courts that have considered this question have adopted a multi-factor test to determine what qualifies and what does not.[10] While application of these factors can vary and will be dependent on the terms of the specific lease at issue, courts typically find that, in addition to the base rent amount, items such as property taxes, insurance and common area maintenance are included in rent reserved.[11]

Section 502(b)(6) is not a formula for calculating a landlord's damages; rather, it acts as a ceiling on the allowed amount of the landlord's claim in bankruptcy. To determine the proper amount of a landlord's claim, it is still necessary to first calculate the actual amount of damages caused by the rejection of the lease under applicable nonbankruptcy law. The allowed claim will then be the lesser of the actual damages or the statutory cap.[12]

Treatment of Credit Support Under § 502(b)(6)

Commercial landlords often require tenants to provide credit support (*e.g.*, security deposits, guaranties or letters of credit) in connection with their lease. Because of their different nature, guaranties and letters of credit are treated differently when it comes to a landlord's rejection-damages claims.[13]

A guaranty acts as a separate claim against the guarantor. Thus, where a landlord has a guaranty agreement in connection with a rejected lease, there will be a direct claim against the lessee and a guaranty claim against the guarantor. Where the guarantor is not a debtor in the bankruptcy, the landlord is free to pursue the nonbankruptcy remedies it has under the guaranty against the guarantor. However, what happens when the guarantor is also a debtor in the same jointly administered bankruptcy cases and covered by the same full-pay plan?

The first consideration is whether the claim against the guarantor will be subject to the cap under § 502(b)(6). The majority of courts that have considered this question have held that a claim arising under a guaranty of a rejected lease is subject to the cap.[14] The second consideration is whether the cap applies separately to the direct claim and the guaranty claim, or whether it applies to them in the aggregate.

As a general rule, when a creditor has a claim against one debtor and a claim against a co-debtor who has guaranteed the original debt, the creditor is entitled to assert the full amount of its claim against both debtors.[15] Therefore, a creditor with a direct claim and a guaranty claim in a jointly administered case gets two claims against two separate debtors: one for the direct claim and one for the guaranty claim. This principle is subject to the "single satisfaction rule" (*i.e.*, the creditor cannot "retain value beyond payment in full").[16] However, the question is what counts as "payment in full" — that is, whether payment of the capped amount of the landlord's claim is considered payment in full or whether the claim is not paid in full until the full amount of the uncapped claim has been paid. In a case where general unsecured creditors are receiving only pennies on the dollar, the question may be irrelevant, as the total amount of the recovery on both claims will not equal the capped amount of either claim. However, under a full-pay plan, a landlord with a co-debtor guarantor could potentially receive a recovery equal to twice the § 502(b)(6) cap (with an upper limit equal to the total amount of the uncapped claim).

This issue has not been directly decided before, but the better argument is likely that the landlord would be entitled to assert both the direct and guaranty claim up to the full capped amount for each claim. Courts have held that satisfaction of an allowed lease-rejection claim, subject to the § 502(b)(6) cap and a subsequent discharge in the lessee's bankruptcy, does not discharge the guarantor's liability for any remaining amounts due beyond the capped amount.[17] If that is the case, then it cannot be possible for the mere coincidence of a joint filing to change the result.

To illustrate this, consider the following scenario: A landlord owns a commercial building in which the debtor is a tenant under a lease with the landlord. One of the debtor's affiliates, the guarantor, has unconditionally guaranteed the debtor's performance under the lease. The debtor files for bankruptcy (but the guarantor does not) and rejects the lease. The landlord's rejection damages under the lease are $2 million. After applying § 502(b)(6), the landlord's allowed claim in the bankruptcy is calculated at $500,000. If the debtor proposes a full-pay plan, the landlord would receive a distribution of $500,000 in full satisfaction of its claim, but the landlord would also still be able to assert the remaining $1.5 million of the original claim against the guarantor (who did not file for bankruptcy). If the guarantor files for bankruptcy, the § 502(b)(6) cap would apply and the landlord would then have an allowed claim in the guarantor's bankruptcy for $500,000. If the guarantor also proposes a full-pay plan, the landlord will end up collecting $1 million on the original $2 million claim.

Now consider the same scenario, only this time both the debtor and guarantor file separate bankruptcy petitions at the same time, have their cases jointly administered (but

7 *Id.* at 207.
8 *Id.* at 207-08 (quoting H.R. Rep. No. 95-595, at 353 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6309).
9 *Id.* at 208. Some courts interpret "15 percent of the remaining term" as applying to the total amount of rent remaining under the lease, while other courts interpret it to apply to the total amount of time remaining under the lease. *See* 4 *Collier on Bankruptcy* ¶ 502.03[7][c] (2021).
10 *See, e.g., In re Foamex Int'l Inc.*, 368 B.R. 383, 391 (Bankr. D. Del. 2007); *In re Andover Togs Inc.*, 231 B.R. 521, 540 (Bankr. S.D.N.Y. 1999); *In re Metals USA Inc.*, No. 01-42530-H4-11, 2004 WL 771096, at *3 (Bankr. S.D. Tex. Jan. 15, 2004).
11 *See, e.g., Foamex*, 368 B.R. at 392; *Metals USA*, 2004 WL 771096, at *3; *In re Farley Inc.*, 146 B.R. 739, 746 (Bankr. N.D. Ill. 1992); *In re Heck's Inc.*, 123 B.R. 544, 546 (Bankr. S.D. W.Va. 1991); *In re Goldblatt Bros. Inc.*, 66 B.R. 337, 345 (Bankr. N.D. Ill. 1986).
12 *See, e.g., In re MDC Sys. Inc.*, 488 B.R. 74, 82 (Bankr. E.D. Pa. 2013) ("Section 502(b)(6) does not impact the amount of the landlord's claim; it determines only the allowed amount of the claim. The claim, independent of the allowance process under § 502(b)(6), must be determined first under applicable nonbankruptcy law ... then compared with and, if necessary, reduced to the statutory maximum provided in § 502(b)(6).").
13 Security deposits present their own unique issues but are beyond the scope of this article.
14 *See, e.g., In re Ancona*, No. 14-10532 CGM, 2016 WL 828099, at *5 (Bankr. S.D.N.Y. March 2, 2016) (collecting cases).
15 *See, e.g., In re LightSquared Inc.*, No. 12-12080 (SCC), 2014 WL 5488413, at *6 (Bankr. S.D.N.Y. Oct. 30, 2014) (holding that guaranty claim remained viable claim until creditor was paid in full).
16 *Id.* at *5.
17 *See, e.g., In re Modern Textile Inc.*, 900 F.2d 1184, 1192 (8th Cir. 1990) ("Although the Bankruptcy Code limits the amount [that] a lessor can claim against the debtor's bankrupt estate following the Trustee's rejection of an unexpired lease, *see* 11 U.S.C. § 502(b)(6)(A) and (B), that limitation does not operate to cut off and extinguish the lessor's claim for amounts in excess of the amount chargeable to the debtor's estate.").

not substantively consolidated) and propose a joint, full-pay plan. Since joint administration is merely a procedure designed to increase administrative convenience and does not affect substantive rights, the result for the landlord should be the same as if the debtor and guarantor had filed separately. That is, the landlord will be able to assert two claims for $500,000, one against the debtor and one against the guarantor, for a total recovery of $1 million on the original $2 million claim.

On the other hand, letters of credit present a different situation, since they are not property of the estate and are subject to the independence principle. The relevant question here is whether proceeds received by a landlord from a letter of credit should be deducted from the capped amount of the claim or the uncapped amount. Both the Third and the Ninth Circuits have held that a letter of credit should be treated like a security deposit and that any proceeds get deducted from the § 502(b)(6) cap amount.[18] In both of these cases, the landlord had filed a claim for its rejection damages, but what happens if the landlord does not file a claim in the bankruptcy?

In *EOP-Colonnade of Dallas Ltd. Partnership v. Faulkner (In re Stonebridge Techs. Inc.)*, the Fifth Circuit held that if a landlord does not file a claim for its rejection damages in the bankruptcy, it is entitled to keep letter-of-credit proceeds that otherwise exceed the § 502(b)(6) cap.[19] The court reasoned that the § 502(b)(6) cap only comes into play if the landlord makes a claim against the estate.[20] Since the landlord did not file a claim, it was entitled to keep the full proceeds of the letter of credit, even though they exceeded the § 502(b)(6) cap. Thus, a landlord with a letter of credit should consider its options carefully when deciding whether and when to draw on a letter of credit and whether to file a claim in a case with a full-pay plan.

Conclusion

While a full-pay plan is certainly better for commercial landlords than the alternative pennies-on-the-dollar case, there are still potential difficulties to navigate and decisions to make, particularly when the landlord has credit support for the lease. In such situations, landlords should be aware that they may be treated as unimpaired creditors even though they are not being paid in full. Landlords should also make sure they understand what effect their credit support will have on the amount of their claim that is ultimately allowed and paid. abi

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18 *PPI Enters.*, 324 F.3d at 210; *AMB Prop. LP v. Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*, 416 F.3d 961, 965 (9th Cir. 2005).
19 430 F.3d 260, 271 (5th Cir. 2005).
20 *Id.* at 270.