WHAT'S A LANDLORD TO DO?

CURRENT ISSUES IN TENANT BANKRUPTCIES

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Selective Table of Contents

Filing Bankruptcy to Reject Leases

I. Can a solvent tenant file bankruptcy solely to reject its lease and limit the landlord's damages claim?

A. Yes

1. In re PPI Enterprises (U.S.), Inc., 228 B.R. 339, 345-6 (Bkrtcy. D. Del. 1998) (Chapter 11 case filed for solvent debtor for the sole purpose of limiting landlord's damage claim under Section 502(b)(6); held: "in evaluating a debtor's good faith, the court's only inquiry is to determine whether the debtor seeks to abuse the bankruptcy law by employing it for a purpose for which it was not intended;" since application of the §502(b)(6) cap was a purpose for which the section was intended, the filing did not violate good faith standards. Cap could not be altered because the statutory language is clear, court may not depart from provisions of Code where "the debtor is solvent or the court otherwise believes the equities of the case might warrant such a departure.");

2. In re W & L Associates, Inc. 71 B.R. 962 (Bkrtcy. E.D. Pa. 1987) (permitting rejection of a contract, even though rejection was the sole purpose of the bankruptcy filing and debtor was apparently solvent.)

3. Bankruptcy filed solely to reject an executory contract and evade a specific performance remedy is permissible. In re Noonan, 17 B.R. 793 (Bkrtcy. S.D. N. Y. 1982); In re Bofill, 25 B.R. 550 (Bkrtcy. S.D.N.Y. 1982)

4. See also, In re Federated Department Stores, Inc., 131 B.R. 808, 817 (S.D.OH. 1991) (applying §502(b)(6) cap even though debtor was solvent and would pay all creditors in full).

B. No

1. In re Chinichian, 784 F.2d. 1440, 1445-6 (9th Cir. 1986) (Debtor's plan revoked as not presented in good faith because the principal purpose of the bankruptcy filing was to reject an executory contract and avoid a specific performance remedy); In re [Tia] Carrere, 64 B.R. 156, 159-60 (Bkrtcy. C.D. Cal. 1986) (Debtor not in good faith where case was filed "for the primary purpose of rejecting a personal services contract."); and see, In re Chi-Feng Huang, 23 B.R. 798, 803 (BAP 9th Cir. 1982) ("We do not doubt that if in the judgment of the bankruptcy court, an estate is solvent in the sense that a 100 percent pay out will occur in the event of liquidation, that it is within the discretion of the court to decline to authorize rejection of

the contract on the grounds that no benefit would accrue to the creditors from the rejection.")

2. In re Waldron, 785 F.2d. 936, 940 (11th Cir. 1986) ("Congress could not have intended that the debt-free, financially secure Waldrons be permitted to engage the bankruptcy machinery solely to avoid an enforceable option contract." Case dismissed for lack of good faith.); In re Newsome, 92 B.R. 941, 943-4 (Bkrtcy. M.D.Fla 1988) (Chapter 13 filed to strong-arm a two party dispute and "to get out of a contractual obligation voluntarily and willingly undertaken" was not in good faith); and see, In re Meehan, 59 B.R. 380 (E.D.N.Y. 1986) (affirming refusal to permit rejection of contract because unsecured creditors would receive 100% recovery in any event.)

3. See also, In re Cardi Ventures, Inc. 59 B.R. 18 (Bkrtcy. S.D.N.Y. 1985) (Chapter 11 was not filed in good faith where only objective was to sell lease over landlord's objection).

4. And see, Furness v. Lilienfield, 35 B.R. 1006, 1012 (D. Md. 1983) (bankruptcy permissible only where there is "real debt and real creditors" and the "petitioner has an honest and genuine desire to use the statutory process to effect a plan of reorganization.").

Limiting Landlord's Claims
For the Rejection of Bad Leases

I. Rejection of a bad lease constitutes a breach, entitling the landlord to a claim for damages. The amount of the landlord's claim is subject to a two-step analysis.

A. First, the claim is limited to the damages which would otherwise be allowable under applicable state law. In re McSheridan, 184 B.R. 91, 96 (BAP 9th Cir. 1995); In re Iron-Oak Supply Corp., 169 B.R. 414, 417 (Bkrtcy. E.D.Cal. 1994) (Klein, Bankr. J.)

B. Second, the Bankruptcy Code provides a statutory ceiling for the amount of that claim. §502(b)(6). Id.

1. "Section 502(b)(6) is designed to 'compensate a landlord for his loss 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.'" In re Lomax, 194 B.R. 862, 865 (BAP 9th Cir. 1996), quoting legislative history.

2. §502(b)(6) 'was not intended to measure damages, but to cap them." In re Financial News Network, Inc., 149 B.R. 348, 351 (Bkrtcy. S.D.N.Y. 1993)

C. "Thus, the landlord's allowable damages are the lower of (1) the statutory cap [under] section 502(b)(6) ignoring mitigation or (2) total rejection damages, which take mitigation into account, available under nonbankruptcy law." Iron-Oak, supra, 169 B.R. at 420.

1. Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231 (Bkrtcy. D.N.D. 1992) (Post termination successes in mitigation "are deducted from the landlord's total actual lease termination damages, before the section 502(b)(6) cap is applied."); In re All for a Dollar, Inc., 191 B.R. 262, 264 (Bkrtcy. D. Mass. 1996) (same).

2. Note, "bankruptcy courts are not free to engage in a balancing of the equities in order to avoid the application of §502(b)(6)'s plain, unambiguous language." In re Federated Department Stores, Inc., 131 B.R. 808, 817 (S.D.Oh. 1991) (affirming application of cap).

II. Overview

A. In all cases, the landlord will be entitled to a claim for unpaid pre-bankruptcy, pre-surrender rent. Cal. Civ. Code §1951.2(a)(1); Bankruptcy Code §502(b)(6)(B).

1. This element of damages accrues only up until the earlier of the bankruptcy filing or the surrender of the leasehold. "Although Congress sought to limit the amount of damages that a landlord could recover from a bankrupt debtor, Congress only placed said limitations on a landlord's claims for post-petition damages, 11 U.S.C. §502(b)(6)(A), while ensuring that said landlord recovers on those damages incurred up to the earlier of lease termination or the petition filing." In re Smith, 249 B.R. 328, 334 (Bkrtcy. S.D. Ga. 2000)

2. Note: Surrender is determined under applicable state law, but generally requires landlord's consent. Iron-Oak, supra, 169 B.R. at 418; Smith, supra, 249 B.R. at 335 ("State law determines whether real estate was surrendered to a lessor for the purposes of §502(b)(6)). This date is the same as 'that date upon which the lease was terminated under state law.'"); In re Blatstein, 1997 WL 560119 (E.D. Pa. 1997) (appeal from bankruptcy court).

a) In Iron-Oak, supra, Judge Klein held that surrender requires the landlord's acceptance under California law. *Accord*, Lomax, supra, 194 B.R. at 865-6, analyzing California law regarding surrender and the termination of leases.

b) Acceptance can be inferred from landlord's conduct inconsistent with continued possession by the tenant.

(i) Landlord's issuance of a "Notice of Belief of Abandonment" constituted acceptance of the debtor's offer of surrender under California law. Lomax, supra, 194 B.R. at 866.

(ii) Does service of a 3 Day Notice with an election to terminate the lease constitute an acceptance of a prior surrender offer?

c) Prior state court judgment may be *res judicata* as to surrender and pre-surrender damages. Blatstein, supra, 1997 WL 560119 at 10-11.

B. As a practical matter, the key issue under both state law and the Bankruptcy Code is the amount of the landlord's prospective damages.

III. Limitations on prospective damages under state law.

A. Under California law, prospective damages are measured by a hypothetical offset.

1. The court offsets the present "worth… of the unpaid rent which would have been earned" after the lease termination against "the amount of such rental loss… which could reasonably have been avoided." Cal. Civ. Code §1951.2(a)(2) and (3).

2. The tenant has the burden of proof respecting the amount of mitigation which the landlord might have achieved.

B. Significantly, where the lease is below market, the landlord will ordinarily have no prospective damages. In re Highland Superstores, Inc., 154 F.3d. 573, 577 (6th Cir. 1998) ("if the lessor has relet the premises at a higher rent, it generally will have no … claim")

1. An exception would be a case in which the lease was only slightly below market and the costs of reletting (e.g., broker's commissions, make ready expenses) would exceed the "profit" in the new lease.

2. If the landlord nonetheless suffered some cognizable loss, recompense might be awarded under Civ. Code §1951.2(a)(4) ("Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessee's failure to perform his obligations under the lease…")

IV. Statutory ceiling on landlord claims for prospective damages: Bankruptcy Code §502(b)(6)

A. The statute:

A landlord's claim "for [prospective] damages resulting from the termination of a lease of real property" shall be limited to "the rent reserved under such lease, without acceleration for the greater of [a] one year, or [b] 15 percent, not to exceed three years, of the remaining term of such lease" measured from the earlier of the bankruptcy filing or the surrender of the leasehold. §502(b)(6).

1. Policy justification: "Section 502(b)(6) is designed to compensate a landlord for the loss suffered upon termination of a lease, while not permitting large claims for breaches of long-term leases, which would prevent other general unsecured creditors from recovering from the estate." In re McSheridan, 184 B.R. 91 (BAP 9th Cir. 1995).

B. What is the "rent reserved"?

1. McSheridan Test

"We hold that the following three-part test must be met for a charge to constitute "rent reserved" under §502(b)(6)(A):

1. The charge must: (a) be designated as 'rent' or 'additional rent' in the lease; or (b) be provided as the tenant's/lessee's obligation in the lease;

2. The charge must be related to the value of the property or the lease thereon; and

3. The charge must be properly classifiable as rent because it is a fixed, regular or periodic charge."

In re McSheridan, 184 B.R. 91, 99-100 (BAP 9th Cir. 1995).

2. Application:

a) "Rent reserved" ordinarily includes "triple net" charges like taxes, insurance and CAM. McSheridan, supra, 184 B.R. at 100; In re Rose's Stores, Inc., 179 B.R. 789 (Bkrtcy. E.D. N.C. 1995)

b) "Rent reserved" includes amortized improvement costs. Blatstein, supra, 1997 WL 560119 at p. 14.

c) In Smith, supra, 249 B.R. at 338-9, the Court concluded that a rent recapture (free rent, recaptured in the event of a default) did not constitute "rent reserved under the lease", applying the McSheridan test.

d) Service charges, reletting costs and liquidated damages are not included in rent reserved, applying the McSheridan test. In re Fifth Avenue Jewelers, Inc., 203 B.R. 372 (Bkrtcy. W.D.Pa. 1996)

e) Attorneys' fees are not "rent reserved", applying the McSheridan test. In re Pacific Arts Publishing, Inc., 198 B.R. 319 (Bkrtcy. C.D. Cal. 1996) (Donovan, Bankr. J.)

3. Compare Cukierman:

a) In re Cukierman, 265 F.3d 846 (9th Cir. 2001). The tenant executed a promissory note to its landlord in connection with the lease, and the lease characterized payments on the promissory note as "further rent".

b) The Ninth Circuit held that the note payments were included among the obligations which must be performed post-petition pursuant to Section 365(d)(3) and hence were entitled to administrative claim status.

c) Arguably the promissory note payments would also constitute "rent reserved" under the McSheridan test. See, Blatstein, supra, 1997 WL 560119 at p. 14. ("Rent reserved" includes amortized improvement costs.)

4. Other cases:

a) Applying a somewhat different test, one court allowed utility charges incorporated in the lease as "rent reserved", but rejected charges which would arise only upon certain contingencies, such as attorneys' fees. In re Conston Corporation, 130 B.R. 449, 455 (Bkrtcy, E.D. Pas. 1991).

b) A prior state court judgment does not have *res judicata* effect so as to override the §502(b)(6) cap. Fifth Avenue Jewelers, supra, 203 B.R. at 382.

c) §502(b)(6) applies only to post-termination damages and "only includes damages anticipated to result from a tenant's failure to fill out the lease term. It does not address damages wholly collateral to the termination event – such things as waste, destruction or removal of leasehold property… damages caused by a tenant's failure to properly repair and maintain the premises are not subject to section 502(b)(6) since that is a separate obligation imposed on a tenant…") Bob's Sea Ray Boats, supra, 143 B.R. at 231.

d) But see the Court's extraordinary analysis in Fifth Avenue Jewelers, supra, 203 B.R. at 379-381: If the date of surrender is the same as "termination of the lease", nothing can be allowed on account of the "rent reserved" *after* the date of surrender, because there is no rent due under a lease after it has been terminated. Applying this analysis, the cap applies only in bankruptcy rejection cases, because in those cases the rejection has retroactive effect; there will be rent reserved under the lease following the date on which the petition was filed.

V. How do you measure the 15%?

A. *Minority Rule – Time*: Next 15% of the months remaining on the lease.

1. Iron-Oak, supra, 169 B.R. at 420 ("The correct interpretation, however, is that Congress intended that the phrase "remaining term" be a measure of time, not rent.")

a) Judge Klein supports his analysis with the argument that the phrase "without acceleration" is meaningful only if the measurement is of time, not rent.

b) Other courts have adopted the same analysis. See careful analysis in Blatstein, supra, 1997 WL 560119 at p. 12-3.

c) Application: multiply the remaining months of the lease by 15%; sum up the rent which will accrue over those next months, giving effect to escalators and scheduled free or reduced rent which will arise during those months.

B. *Majority Rule – Rent*: 15% of the total rent to be paid over the remaining term of the lease.

1. In re Gantos, 176 B.R. 793 (W.D. Mich. 1995) (noting anomalies in minority rule where rent fluctuates over the lease term).

2. In re New Valley Corporation, 2000 WL 1251858 (D. N.J. 2000) *aff'ing* bankruptcy court decision adopting the majority view ("the '15 percent' does not refer to time; it stands alone without reference to time or rent.")

VI. When should you choose the 15% limitation instead of one year's rent?

A. Where rent is flat, if more than 6 ½ years remain in the term.

B. If rent is back-end loaded and the Court has adopted the majority view (i.e., 15% of total rent, not time).

VII. Post-bankruptcy developments:

A. §502(b)(6) does not apply where the lease has been assumed.

1. Where a lease is assumed and thereafter rejected, the landlord will hold an administrative claim for rejection damages. In re Airlift Int'l, Inc. 761 F.2d. 1503, 1509 at n. 5 (11th Cir. 1985).

2. That claim is not limited by §502(b)(6). In re Merry–Go-Round Enterprises, Inc., 180 F.3d. 149, 161 (4th Cir. 1999); In re Klein Sleep Products, Inc., 78 F.3d. 18, 22-3 (2nd Cir. 1996).

B. Payment of post-bankruptcy administrative rent does not affect or reduce the landlord's rejection damages claim. In re Atlantic Container Corp., 133 B.R. 980, 989 (Bkrtcy. N.D. Ill. 1991)

Collateral and Letters of Credit

I. Can the landlord solve the §502(b)(6) problem with collateral?

A. The cap established by §502(b)(6) governs the landlord's claim, not merely its unsecured claim.

1. The security deposit or other collateral must be *applied to claim as capped* by §502(b)(6).

a) Oldden v. Tonto Realty Co., 143 F.2d. 916 (2nd Cir. 1944).

b) Legislative history of §502(b)(6) suggests Oldden will remain good law under the Bankruptcy Code. See extensive discussion in All for a Dollar, supra, 191 B.R. at 264; Conston Corporation, supra, 130 B.R. at 452.

c) "[T]he landlord will not be permitted to offset his actual damages against his security deposit and then claim for the balance under [the §502(b)(6) cap]. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under [§502(b)(6)]." Blatstein, supra, 1997 WL 560119 at p. 17.

2. Instructive is the case of In re Bank of New England Corporation, 187 B.R. 405 (Bkrtcy. D. Mass. 1995), addressing a comparable cap on employee termination claims. §502(b)(8).

a) In Bank of New England, the debtor had fully collateralized a severance obligation to its manager. The Court determined that the severance claim was limited by the amount of the statutory cap; one year's compensation pursuant to §502(b)(7); which was less than the amount of the collateral.

b) The Court required a surrender of the excess collateral to the debtor's trustee, but allowed the manager interest and attorneys fees on his (reduced) claim as an oversecured creditor. §506(b).

3. Consequence: A landlord who holds a security deposit in excess of one year's rent must expect to surrender that excess if the tenant files bankruptcy.

a) A few years ago landlords built campuses for dot.coms, premised upon a 12-15 year lease and a 3 year security deposit. Those landlords face substantial exposure in a tenant bankruptcy.

B. The key issue here is that the collateral is provided *by the tenant* to secure performance of *the tenant's obligations* under the lease.

1. This is so because the landlord's claim *against the tenant* is capped, and so it is also capped against the tenant's property; i.e., collateral posted by the tenant. In re Handy Andy Home Improvement Centers, Inc., 222 B.R. 571, 574-75 (Bkrtcy. N.D. Ill. 1998)

2. A cash security deposit is merely a type of collateral provided by the tenant (potentially governed by more restrictive provisions of California law; see below).

C. Note: there may be additional restrictions on the use of a security deposit under California law. See, St. James, "Landlord Beware: Will a Security Deposit Survive a Bankruptcy?" 26 CAL. BANKR. J. 44 (2001)

II. Can the Landlord solve the §502(b)(6) problem with a guarantee or a third party pledge?

A. Ordinarily, a third-party guarantee and a pledge of a third party's assets to secure such a guarantee will *not* be affected by §502(b)(6) and the tenant's bankruptcy case.

1. This is so because a guarantee is a separate and independent obligation, not (necessarily) affected by a change in the obligation of the primary obligor.

a) Analytically, a bankruptcy discharge is viewed a releasing the primary obligor of its personal liability rather than extinguishing the underlying debt, so as to leave the obligations of the guarantor unaffected. Matter of Edgeworth, 993 F.2d. 51, 53 (5th Cir. 1993).

b) The guarantor, if a debtor in a bankruptcy case, may independently avail itself of the §502(b)(6) limitation with respect to the lease guarantee claim, regardless of whether the tenant itself is in bankruptcy. In re Arden, 176 F.3d 1226 (9th Cir. 1999)

2. Thus, it is well established in the Ninth Circuit that the bankruptcy of the primary obligor cannot affect the obligation of the guarantor. "A bankruptcy court does not have the power to discharge the liabilities of a bankrupt's guarantor." Star Phoenix Mining Co. v. West Bank One, 147 F.3d. 1145 (9th Cir. 1998); see also, Underhill v. Royal, 769 F.2d. 1426 (9th Cir. 1985) (Provision of confirmed Chapter 11 Plan which prevented collection from guarantor was unenforceable).

3. In the context of a real property lease and the application of §502(b)(6) to a rejection damages claim against the tenant's bankruptcy estate, it has been expressly held that "the liability of a guarantor for a debtor's lease

obligations is not altered by the Trustee's rejection of the lease." In re Modern Textile, Inc., 900 F.2d. 1184, 1191 (8th Cir. 1990)

a) In re Western Real Estate Fund, Inc. 922 F.2d. 592, 601 (10th Cir. 1990) (bankruptcy does not "bar litigation against third parties for the remainder of the discharged debt… [even where] the creditor's claim is based on an executory contract that is both rejected under section 365(a) and subject to limitation in amount [by §502(b)(6)]";

b) Bel-Ken Associates, Ltd. Partnership v. Clark, 83 B.R. 357 (D. Md. 1988) (guarantor obligation not affected by tenant's bankruptcy and its invocation of §502(b)(6)).

B. Drafting issues:

1. It is essential for these purposes that the guarantee and any collateral pledged to secure it is separate and distinct from the lease obligation.

2. Potential Problems:

a) Collateral pledged by a third party to secure the tenant's lease obligation may well be subject to §502(b)(6) limitation, since arguably the collateral only secures the amount the court determines the tenant must pay.

b) Likewise, a guarantee which is sharply limited to "amounts which the tenant must pay", like reimbursement / indemnity insurance policies, may be subject to the §502(b)(6) limitation.

3. Solution:

a) In order to avoid §502(b)(6) problems, a third party must incur a separate and independent obligation to the Landlord, and *that* obligation must be secured by the third party's property.

b) Note: Even if the transaction is well documented, it remains subject to "form over substance" challenges. For example, if a subsidiary is created for the purpose of guaranteeing the lease, and the tenant capitalizes it with the very collateral which it is to post to secure its guarantee, the Court may well conclude that in substance the tenant provided the collateral, and hence the Section 502(b)(6) limitation applies.

III. Are Letters of Credit subject to the §502(b)(6) limitation?

A. As a general rule, Letters of Credit are completely unaffected by the tenant's bankruptcy filing. See generally, Winick, "Tenant Letters Of Credit; Bankruptcy Issues For Landlords And Their Lenders" 9 AM. BANKR. INST. L. REV 733 (2001)

1. Letters of Credit are governed by the "independence principle", which holds that the obligations of the Bank to the Landlord are entirely independent of the obligations of the Tenant to the Landlord.

a) Matter of Compton Corp., 831 F.2d. 586, 590 (5th Cir. 1987) ("[T]he independence principle is necessary to insure 'the certainty of payments for services or goods rendered regardless of any intervening misfortune which may befall the other contracting party.'")

b) "Property of the estate does not include the proceeds of a letter of credit paid to a creditor of the debtor who is the beneficiary of the letter." 5 COLLIER ON BANKRUPTCY, ¶ 549.04[1] (15th ed. 2000).

2. Thus, the automatic stay does not prevent post-bankruptcy draws on a Letter of Credit. Willis v. Celotex Corporation, 978 F.2d. 146 (4th Cir. 1992)

B. Practical Issues: Although the Letter of Credit is an independent obligation, where the tenant files bankruptcy, the Landlord should approach a draw on the letter of credit with caution.

1. As a technical matter a landlord may often be entitled to draw the entire letter of credit immediately upon the occurrence of a bankruptcy filing, even though the lease is current.

a) This is so because most leases include a bankruptcy filing as an event of default and most letters of credit permit a draw upon certification that an event of default has occurred.

b) Even though the bankruptcy default is ineffective against the tenant (due to Section 365(e)(1)'s invalidation of so called *ipso facto* clauses), the principle of independence permits the landlord to invoke it against the Bank in order to draw on the letter of credit.

c) Note: One court enjoined the landlord from drawing on the letter of credit where there was no monetary default and the sole basis for the draw was breach of the *ipso facto* clause. In re Metrobility Optical Systems, Inc., 268 B.R. 326 (Bkrtcy. D. N.H. 2001)

2. A premature draw on the Letter of Credit may be the beginning of a new and serious problem.

   a) Most leases require funds drawn from a Letter of Credit to be applied against damages suffered by the Landlord. Where the Landlord has suffered no monetary damages – or its damages have been much less than the amount drawn on the Letter of Credit (or arguably so, due to a dispute with the Tenant about those damages) – what becomes of the "excess draw"?

      (i) While leases are often silent, they do not seem to contemplate that the Landlord may keep the excess draw as a "bonus".

      (ii) Rather, the excess draw is almost certainly analyzed as "cash collateral" for bankruptcy purposes; see, Section 363(a).

3. Converting a letter of credit into cash collateral is ordinarily undesirable.

   a) The Landlord may not apply cash collateral against its damages without a Court Order.

   b) The Tenant may seek an Order requiring the Landlord to turn over the cash collateral so that the tenant may use it in the operation of its business. §363(c)(2).

4. As a consequence, a Landlord is almost always best served by deferring any draw on the Letter of Credit until the lease has been rejected.

   a) Upon rejection, the Landlord will have clear and undisputable damages, ordinarily well in excess of the Letter of Credit amount, eliminating any basis for application of a "cash collateral" analysis.

   b) In re Farm Fresh Supermarkets of Maryland, Inc., 257 B.R. 770 (Bkrtcy. MD. 2001) (holding that trustee in bankruptcy could not recover proceeds of landlord's draw under a letter of credit; curiously, the lease had previously been assumed and assigned, presumably curing the default which had justified the call on the letter of credit.)

C. Illustrative Example:

1. Letter of Credit:

   a) Assume a lease which requires $1 million per year in rent. The Landlord holds a $2 million letter of credit. When the lease is

rejected in the tenant's bankruptcy case, the Landlord promptly mitigates and suffers $5 million of allowable damages.

b) As a result of §502(b)(6), the Landlord's claim against the bankruptcy estate is limited to $1 million (one year's rent), leaving it with $4 million of "unrecognized damages".

c) As a result of the independence principle, however, the Landlord may apply the $2 million letter of credit against its unrecognized damages, preserving its $1 million unsecured claim against the bankruptcy estate.

2. Security deposit:

a) Assume in the foregoing example that the Landlord held a $2 million cash security deposit instead of a letter of credit.

b) As a result of §502(b)(6), the Landlord's claim against the bankruptcy estate is limited to $1 million (one year's rent).

c) Since the security deposit only secures the Landlord's allowed claim against the bankruptcy estate, it must surrender to the bankruptcy estate its "excess security deposit" ($2 million security deposit less $1 million allowed §502(b)(6) claim) and treat its claim against the bankruptcy estate as having been completely satisfied.

D. Challenges to Letter of Credit Transactions:

1. Lease Language:

a) Many leases (unfortunately) describe the Letter of Credit as a "security deposit", arguably subjecting it to state law restrictions on a security deposit; see, Cal. Civ. Code 1950.7(c); and potentially invoking Oldden v. Tonto Realty Co., 143 F.2d. 916 (2nd Cir. 1944) and the principle that a security deposit must be applied against the 502(b)(6) claim.

b) This would seem to be the best explanation for the ruling in In re PPI Enterprises (U.S.), Inc., 228 B.R. 339, 350 (Bkrtcy. D. Del. 1998) in which the court defined the landlord's letter of credit as a "security deposit" and then applied the general principle that a security deposit may be credited against the capped §502(b)(6) claim, without discussing the independence principle or providing an analysis which recognized the unique characteristics of a letter of credit. See, Winick, "Tenant Letters Of Credit; Bankruptcy

Issues For Landlords And Their Lenders" 9 AM. BANKR. INST. L. REV 733, 752 at fn 81 (2001)

c) PPI Enterprises appears to be the only case in which a letter of credit recovery was applied against the landlord's capped 502(b)(6) claim. Compare, In re Farm Fresh Supermarkets of Maryland, Inc., 257 B.R. 770 (Bkrtcy. MD. 2001).

2. Form Over Substance: Although the independence principle suggests that §502(b)(6) should have no effect on a Letter of Credit, a potentially serious "form over substance" challenge may exist.

a) In most cases, the bank which issues the Letter of Credit to the landlord requires that the tenant post collateral, typically a certificate of deposit, to secure repayment to the bank if there is a draw under the Letter of Credit.

b) When viewed in terms of the prior example, this presents anomalous results:

(i) As noted above, if the tenant provides the Landlord with a $2 million cash security deposit, §502(b)(6) will allow the bankruptcy estate to recover $1 million and treat the Landlord's claim as fully satisfied.

(ii) If the tenant provides that same $2 million to the Bank as collateral for a Letter of Credit, however, the Landlord will keep the full $2 million draw on the letter of credit and will hold a $1 million unsecured claim against the bankruptcy estate.

(iii) There seems to be no policy or principle which would justify these contrasting results.

c) In all likelihood, the degree of success enjoyed by a bankruptcy estate attempting to use a "form over substance" argument to evade the independence principle will turn on the Landlord's involvement in the structuring of the transaction.

(i) If the Landlord required a Letter of Credit instead of a cash security deposit in order to evade §502(b)(6), a "form over substance" challenge would seem to have merit.

(ii) Where, as is ordinarily the case, the Landlord expressed no preference and the tenant chose to use a Letter of Credit (say, to obtain more favorable accounting treatment), a form over substance challenge should not prevail.

Different structures often have different legal consequences, and absent a showing of an intent to evade or avoid a natural consequence of a transaction, the transaction should not be re-characterized.

3. Caution: The foregoing analysis applies only where funds are received from the bank on account of a draw under the letter of credit. Where funds are received directly from the tenant, the existence of a Letter of Credit may have no beneficial effect. See, In re Powerine Oil Company (Creditors Committee v. Koch Oil Co.) 59 F.3d. 969 (9th Cir. 1995) (Creditor who held a letter of credit accepted money from the debtor in lieu of a draw on the letter of credit; held, the payment may be avoidable as a preference).

   a) Likewise, if the letter of credit is provided in an attempt to make a preference, it may be avoidable. Matter of Compton Corp., 831 F.2d. 586, 590 (5th Cir. 1987) (Where creditor obtained a letter of credit from debtor in order to receive a preference, indirect preference could be recovered from creditor without impairing the independence principle); In re Richmond Produce Co., Inc., 118 B.R. 753, 760-61 (Bkrtcy. N.D. Cal. 1990) (Tchaikovsky, Bankr. J.) (Where fraudulent conveyance was effected through the medium of a letter of credit, indirect transfer could be recovered from the beneficiary of the letter of credit without impairing the independence principle.)