

Special Report

Managing Expectations in a Declining Real Estate Market: *Treatment of Security Deposits and Letters of Credit Under the Bankruptcy Code*

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Traditionally, commercial landlords attempt to rely on long-term leases as protection from fluctuations in the rental market. However, as the already tenuous real estate market continues to decline and bankruptcy filings begin to increase, the commercial landlord can no longer take comfort in that very same long-term lease. In situations where a lessee may be paying an above market rent, the commercial landlord is in a vulnerable position of finding itself on the losing side of a lease rejection from a bankrupt tenant.

Lease Rejection Under the Bankruptcy Code

When the bankrupt debtor is a lessee under a lease with an above market rent, the debtor's continued performance under that lease can drain the bankruptcy estate of its already limited funds. In order to protect the estate from such a drain of cash, the Bankruptcy Code allows a debtor to reject unexpired leases that it deems unnecessary to the continued operation of the debtor. The lease rejection effectively terminates the lease, allows the debtor to walk away from the premises without making any further rent payments, and generates a general unsecured claim in favor of the landlord.

The Lease Rejection Damages Cap

The landlord's lease rejection damage claim, aside from being relegated to general unsecured status, is further limited by a damages cap pursuant to Bankruptcy Code Section 502(b)(6). The 502(b)(6) cap was designed to ensure that landlords holding long term leases could not recover an excessive amount from the estate to the detriment of the other unsecured creditors in the case. Generally, the cap

limits the landlord's claim to the amount of unpaid rent reserved under the lease for the greater of (i) one year, or (ii) 15 percent of the remaining term of the lease, not to exceed three years.

Cash Security Deposits and the 502(b)(6) Cap

It is well settled law that a cash security deposit- required by landlords under the terms of most real property leases – is applied against the lease rejection claim after the 502(b)(6) cap reduces the landlord's claim. Thus, the landlord's claim for lease rejection damages is subject first to the 502(b)(6) cap and second to reduction by whatever security deposit is held by the landlord.

Letters of Credit and the 502(b)(6) Cap

But what happens to a lease rejection damages claim when, rather than a cash security deposit, a landlord holds a letter of credit as collateral? Specifically, in light of the treatment of cash security deposits under the Bankruptcy Code, landlords in recent years have begun to ask for letters of credit from their long-term tenants, in an attempt to protect their damages claims in the event of a tenant bankruptcy. Letters of credit ordinarily involve three separate agreements: (i) the lease agreement between the landlord and tenant; (ii) the agreement between a tenant and the letter of credit issuer; and (iii) the letter of credit agreement to pay under certain circumstances between the issuer and the landlord. Because the funds required to be paid under the letters of credit do not go directly from the bankrupt tenant to the landlord, landlords often believe that letter of credit proceeds fall outside of the 502(b)(6) cap.

Despite this reasoning, courts have often likened letters of credit to security deposits. Courts have consistently reasoned that even when the term "security" or "security deposit" is not used to describe a letter of credit provided as security for a lease, the letter of credit was nevertheless viewed and treated as a typical security deposit by both landlord and tenant. As such, courts appear most consistently to treat letters of credit like typical cash security deposits and hold that letter of credit proceeds should be applied against a landlord's capped claim.

Where Should a Landlord Go From Here

Clearly, the treatment of letters of credit in the same manner as security deposits is a very pro-debtor stance taken by bankruptcy courts. Currently, no letter of credit loopholes appear to exist under the law. Therefore, landlords must be vigilant in investigating and analyzing the creditworthiness of prospective tenants before entering into long term leases.

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