Secured Letters Of Credit and the Bankruptcy Code § 502(b)(6) Cap on Lease Rejection Damages

Aug 01 2005

Posted By: David I. Cisar & Rebecca H. Simoni

Practice Area: Restructuring and Insolvency & Banking and Commercial Finance

Bankruptcy Code § 502(b)(6) "caps" a landlord's lease rejection damages claim against a debtor/tenant at the greater of (i) one year's rent or (ii) 15 percent of the unpaid rent for the remaining term, not to exceed three years' rent (the "Rent Cap"). A landlord's claim for damages in excess of the Rent Cap is disallowed. The favored method of trying to avoid the Rent Cap is to require the tenant to obtain a standby letter of credit, upon which the landlord may draw if the tenant defaults. The tenant's lender may secure the reimbursement obligation under the letter of credit agreement with collateral of the tenant, which sets the stage for the question of who loses if the letter of credit proceeds exceed the Rent Cap: the landlord, the debtor/tenant, or the letter of credit issuer.

Some landlords go the extra step, in an effort to avoid this dilemma, of requiring that the issuer commit not to secure the reimbursement obligation with assets of the tenant. In addition, the question arises whether the proceeds of the letter of credit should be applied against the landlord's allowed claim under the Rent Cap, or whether the landlord may recover the allowed claim under the Rent Cap from the debtor while applying the letter of credit proceeds against the disallowed portion of the claim (that part that exceeds the Rent Cap).

In the recent case of *In re Mayan Networks Corp*., 306 B.R. 295 (B.A.P. 9th Cir. 2004), Judge Klein, in a concurring opinion, concluded that the secured letter of credit issuer should suffer the loss if the proceeds of the secured letter of credit exceed the Rent Cap. The case, especially the concurring opinion, has generated considerable discussion in bankruptcy circles and among letter of credit issuers.

The real issue on appeal was whether the letter of credit proceeds were to be applied against the claim under the Rent Cap or to the remainder (the disallowed portion) of the claim. On this issue, the primary opinion cites to the legislative history of § 502(b)(6) and concludes (based on *Oldden v. Tonto Realty Corp*., 143 F.2d 916 (2d Cir. 1944), which is cited in the legislative history) that the letter of credit proceeds are to be applied against the claim under the Rent Cap, thus leaving the landlord with a reduced allowed claim. The case did not present the issue addressed by the concurring opinion because the $648,966 letter of credit at issue which was secured by a $650,000 deposit of the debtor's cash was much less than the claim under the Rent Cap of $2,701,535.306 B.R. at 297. Thus, the concurring opinion is only dicta (which begs the question of whether the issue discussed was briefed).

In addition to being dicta, the concurring opinion's patchwork of references to security deposits and the setoff provisions of § 553, the turnover provisions of § 542, and the temporary disallowance provisions of § 502(d), is simply not persuasive in the light of the purpose of § 502(b)(6) and the application of § 506.

First, the concurring opinion's reliance on the legislative history of § 502(b) should be revisited. The legislative history states that the Rent Cap is premised on two considerations: (1) the contingent nature of lease rejection damages and the resulting difficulty of proof (in fact, prior to the 1934 bankruptcy amendments, a landlord's lease rejection damage claim was not even "provable"); and (2) the fact that landlord claims are qualitatively different in that the landlord retains the underlying asset, the real estate. 124 Cong. Rec., H11,093 94 (daily ed. Sept. 28, 1978). The legislative history focuses on the excess claim a landlord would have under a rejected long term lease. Despite this focus on the overly-large, contingent, questionable nature of a landlord's claim in the legislative history, the concurring opinion in *Mayan Networks* visits the Rent Cap damages limitation on the letter of credit issuer, whose position exhibits none of those features, and who had the foresight to take security for its contractual reimbursement right against the tenant.

Second, the concurring opinion's analogy of a letter of credit to a security deposit is unpersuasive, as the security deposit relationship (between the landlord and tenant) does not involve an adversely affected third party (the issuer) who is not the direct object of the Rent Cap and whose claim is secured by a security interest. The concurring opinion argues that the claim of a landlord who holds a security deposit that exceeds the Rent Cap claim is temporarily disallowed under § 502(d) until the excess amount of the security deposit is turned over to debtor under § 542. The concurring opinion then posits that, because the purpose of the letter of credit is similar to a security deposit, they must be treated the same. However, the turnover provisions of § 542 cannot be invoked to defeat a secured creditor's rights under § 506 (see below).

Third, a significant part of the concurring opinion seeks to limit the rights of the secured letter of credit issuer based on § 502(e) and § 509. Section 502(e) typically applies to co debtors, sureties and guarantors. *Collier on Bankruptcy*, 502.06[2][b] (15th ed.2003). It disallows claims for reimbursement or contribution of an entity that is liable with the debtor on, or that has secured the claim of a creditor, to the extent that: (a) the creditor's claim is disallowed, (b) the claim for reimbursement or contribution is contingent, or (c) the reimbursement or contribution creditor also asserts a subrogation claim. The primary purpose of § 502(e) is to prevent the assertion of duplicate claims when, for example, the reimbursement claim is still contingent or the creditor has both a reimbursement and subrogation claim. Id. at 502.06[2][c], [d] and[e]; *Great American Federal Savings & Loan Association v. Adcock Excavating Inc*., 1990 WL 51219 (N.D. Ill. 1990)(which discusses the purpose and legislative history behind § 502(e)). Based on its analysis, the concurring opinion concludes that § 502(e) somehow invalidates the issuer's secured reimbursement claim.

Collier on Bankruptcy states that: "The importance of section 502 or section 509 election is relevant only to secured claims. A co debtor should elect treatment as a reimbursement or contribution claimant if it has a lien on the debtor's property. On the other hand, a co debtor should elect subrogation if the underlying creditor's claim is secured." Id. at 502.06[2][e] (citing to 124 Cong. Rec., H11,094 (daily ed. Sept. 28, 1978). *Collier* validates secured reimbursement claims notwithstanding potential § 502(e) disallowance.

Section 509 validates subrogation claims, but subordinates them to the claim of the primary creditor until its claim is paid, for the purpose of avoiding duplicate claims. The application of § 509 to the secured reimbursement right of the letter of credit issuer is questionable, as at most it leads to subordination of contingent subrogation claims. The letter of credit issuer is relying not on subrogation to the landlord (the landlord does not hold any collateral) in asserting its lien rights, but on its reimbursement contract. Moreover, if subrogation were really a problem the issuer could simply waive it and rely on its reimbursement contract.

The concurring opinion gives the example that if the estate pays a landlord its claim under the Rent Cap and a secured guarantor pays the landlord the disallowed balance of the claim, the guarantor's reimbursement claim against the estate is disallowed under § 502(e), and the guarantor must return its collateral under § 542. *Mayan Networks*, 306 B.R. at 307. However, the opinion makes no mention of § 506 ("Determination of Secured Status") in its analysis.

Subsection 506(d)(1) provides:

(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless-

(1) such claim was disallowed only under section 502(b)(5) or 502(e)….

Even if the guarantor's or issuer's reimbursement claim is disallowed based on 502(e), that does not result in the issuer losing its lien, pursuant to § 506(d)(1). This was the conclusion of the court in *Tri Union Development Corporation,* 314 B.R. 611 (Bankr. S.D. Texas 2004) where the court, dealing with contingent bonding company claims (which were disallowed because they had not ripened) concluded: "The Court agrees. The bonding company's liens survive the determination that [its] claims are disallowed under § 502(e)(1). [It] may retain its lien position until such time as its contingent liability is eliminated." Id. at 622. This is the most direct answer to the issue.

Conclusion

While the concurring opinion in *Mayan Networks* purports to be a holistic analysis of numerous provisions of the Bankruptcy Code, the numerous analogies do not shed light on the issue. After rejecting the independence principle, the opinion concludes that a letter of credit issuer is covered by § 502(e), and therefore, to the extent the reimbursement claim exceeds the Rent Cap, it is to be disallowed. There is a significant hiatus to the next conclusion, that therefore the issuer must surrender its collateral, which is bridged only by analogy to § 542. The opinion ignores § 506(d)(1) which states that even though the reimbursement creditor's (issuer's) claim is disallowed, it retains its lien. Under § 506(d)(1), the secured letter of credit issuer does not bear the insolvency risk.

As noted by the primary opinion in *Mayan Networks*, letters of credit do not enjoy a comfortable place in bankruptcy law. However, they have been analyzed under the bankruptcy law in the context of an indirect preference. When an unsecured creditor shores up his position by obtaining a letter of credit within the preference period, and the issuer secures the letter with collateral of the debtor, it is not the issuer that loses, but the previously unsecured creditor. *In re Air Conditioning Inc*., 845 F.2d 293(11th Cir. 1988); *In re Compton Inc.,* 831 F.2d 586 (5th Cir. 1987). This conclusion is consistent with the objective of the preference statute.

Similarly, for secured letters of credit that are drawn when a tenant defaults, the landlord, to whom the Rent Cap limitation is directed, should lose. This is essentially the conclusion reached in *In re Stonebridge Technologies Inc*., 291B.R. 63 (Bankr. N.D. Texas 2003) where the court recognized that the independence principle of letters of credit was not the issue, and focused on recovering the excess proceeds received by the landlord, after apply the Rent Cap. Fundamental principles of letters of credit and secured transactions should not be sacrificed, especially when the letter of credit issuer was not the source of the problem § 502(b)(6) was intended to solve.
