

# Finally, a Limit on a Solvent Tenant's Ability to Use Bankruptcy to Shortchange a Landlord

Copyright © 2005 Thomson/West. Originally appeared in the Spring 2005 issue of Real Estate Finance Journal. Reprinted with permission.

Phillip K. Wang

**A recent decision by the U.S. Court of Appeals for the Third Circuit precluded a solvent tenant from filing bankruptcy solely to cap a landlord's damages. As explained in this article, the Third Circuit's decision advances essential bankruptcy policies.**

In an economic downturn, the commercial real estate market is often depressed, lease defaults are common and owners and managers find themselves spending more of their time chasing existing tenants for rent and less time on new leasing matters. The last thing an owner or manager wants to be stuck with during these times is a tenant in bankruptcy. On the other hand, a tenant attempting to decide whether to ride out a difficult cycle or to close shop will sometimes choose the latter, not because the tenant is necessarily insolvent, but rather to cap its landlord's damages claim for a breach of the lease and thereby maximize the return to the tenant's equity holders at the expense of the landlord. The State of Delaware—the leading venue for developing law in this area—has been allowing tenants to do just that. However, the tide may finally be turning in the landlords' favor.

## ***The Integrated Telecom Ruling***

In the case entitled *In re Integrated Telecom Express, Inc.*, a financially healthy company that was going out of business was not permitted to file for bankruptcy solely to take advantage of a provision of the Bank-

ruptcy Code which sharply limits the amount a landlord may recover for termination of a long-term lease.<sup>1</sup> The *Integrated Telecom* case is significant because it finally provides a limit to a string of decisions allowing debtor-tenants to file bankruptcy to cap a landlord's lease termination damages. The case is also critical because it was issued by the Third Circuit, the jurisdiction governing Delaware, the still popular venue for bankruptcy filings.

Integrated was a supplier of software and equipment to the broadband communications industry. In the summer of 2000, at the absolute height of the real estate frenzy in Silicon Valley, Integrated entered into a ten-year lease for commercial space at the then prevailing market rate. Almost immediately after occupying its new premises, the market for Integrated's products effectively vanished, which caused Integrated to suffer net losses of over \$36 million in 2001. Having endured such poor market timing, unable to find a suitor for its business and unable to change its business model, Integrated prepared a plan for liquidation. Two items dominated its dissolution plan:

- (1) the resolution of outstanding liability to its landlord, which was estimated to be about \$26 million; and
- (2) the sale of its intellectual property rights.

Phillip K. Wang, Partner in the San Francisco office of Gordon & Rees LLP, may be reached at [pwang@gordonrees.com](mailto:pwang@gordonrees.com).

### **Capping The Landlord**

When the landlord would not accept \$8 million to settle its claim for damages, Integrated filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in Delaware. One of Integrated's stated reasons for filing its bankruptcy petition was its desire to take advantage of the Section 502(b)(6) cap on the landlord's claim. The landlord moved to dismiss the case on the basis that the debtor-tenant did not file its petition in good faith. The bankruptcy court denied the motion, a decision which was affirmed by the district court.

The Third Circuit, however, relying heavily on the fact that the company was highly solvent and had an overabundance of cash at the time of the filing—over \$105 million in unrestricted cash in the face of at most \$32 million in possible total liabilities—held that the Delaware bankruptcy court erred by denying the landlord's motion to dismiss. Integrated did not have a right to pursue a Chapter 11 filing on the grounds it was losing money at a substantial rate and, as a result, had gone “out of business.” According to the Third Circuit, this was not enough to show that the debtor was in “financial distress.” The court found that the Bankruptcy Code does not allow for the filing of a Chapter 11 petition “by a financially healthy debtor, with no intention of reorganization or liquidating as a going concern” and that the debtor had “no reasonable expectation” that its Chapter 11 proceedings would “maximize the value of the debtor's estate for creditors.” Instead, the evidence showed that the debtor filed the petition “solely to take advantage of a provision of the Bankruptcy Code” that limits claims on long-term leases.<sup>2</sup>

### **Precluding Solvent Tenants**

By precluding a solvent tenant from filing bankruptcy solely to cap a landlord's damages, the Third Circuit's decision in *Integrated Telecom* advanced essential bankruptcy policies. The purpose underlying the claim cap, specifically, precluding a landlord with a claim under a long-term lease from disproportionately dominating the recovery for unsecured creditors, would not be served if a solvent tenant were allowed to cap a landlord's claim to benefit solely the tenant's equity

holders. Also, permitting a debtor to benefit equity holders at the expense of landlord-creditors would be an end-run around a core principle of bankruptcy—the “absolute priority rule,” which allows shareholders to retain equity interests only after creditors have been paid in full.

The *Integrated Telecom* decision has a significant effect on the ownership of commercial real property in California in two ways. First, the case is binding authority over a California landlord if a tenant files for bankruptcy in the Third Circuit, which includes Delaware, New Jersey, and Pennsylvania. Second, due to the fact that the Delaware Bankruptcy Court is a leading forum in developing new bankruptcy law, this case can be highly persuasive in bankruptcy cases filed outside of the Third Circuit. Property owners and managers who are confronted with a defaulting tenant threatening to file for bankruptcy should accumulate as much information as possible relative to the tenant's financial condition, including the amount of available cash and total liabilities (other than the lease). Given the strong policy arguments in favor of limiting solvent tenants from using the bankruptcy law as a means to redirect funds from a landlord to the tenant's shareholders, any information on the financial condition of the tenant will be helpful in assessing whether the tenant is indeed abusing the bankruptcy process at the landlord's expense.

---

<sup>1</sup> The “claim cap” under Section 502(b)(6) of the Bankruptcy Code limits a landlord's damages resulting from the termination of a real property lease to, in many instances, an amount equal to rent for one year. The cap is particularly stinging for a landlord where a debtor is solvent because all allowed (and not capped) claims of creditors will be paid in full in such a situation with the remaining assets returned to equity holders.

<sup>2</sup> There is a California bankruptcy court that concurs with this analysis. In *In re Liberate Technologies*, 314 B.R. 206 (Bankr. N.D. Cal. 2004), the California bankruptcy court held that a Chapter 11 plan filed by a solvent debtor seeking to force its landlord to accept a “rent cap” in lieu of damages was in bad faith and dismissed the petition. The California bankruptcy court reasoned that although the debtor faced serious business difficulties, it still had sufficient cash with which to pay off its liabilities and did not have a genuine need for bankruptcy relief.