

BUSINESS BANKRUPTCY DEVELOPMENTS UNDER BAPCPA AND OTHER CURRENT ISSUES

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I. RECLAMATION

Historically, the months and days prior to the filing of a bankruptcy case were spent getting financing in order, determining what professionals needed to be hired, determining who may be a critical vendor, and like activities. With the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “BAPCPA” or “2005 Act”), those activities are still important, but a few additional items need to be added to the list: Ensuring necessary goods are available, but not purchased within 45 days of the petition if not covered by a floating lien, ensuring that goods that will not be used immediately prior to the filing or postpetition are not ordered within 20 days of the petition date; the analysis process for non-residential real property leases needs to be substantially underway – particularly if there are a significant number of leases; and some idea regarding the exit strategy needs to be considered, particularly if there are competing constituencies who may wish to offer differing plans.

A. Goods Sold in the Days Before the Petition Date

Prior to the 2005 Act, Title 11 of the United States Code (the “Bankruptcy Code”)¹ provided some level of protection to sellers of goods who delivered those goods to the debtor in the days preceding the filing of the debtor’s petition by incorporating state law reclamation rights, as provided by the Uniform Commercial Code (“UCC”), into the Bankruptcy Code in the form of Section 546(c). However, the amendments made by the 2005 Act via amended Section 546(c)² and the inclusion of Section 503(b)(9) dramatically change these rights.

¹ Unless otherwise specified, Section numbers refer to Sections of the Bankruptcy Code.

² 11 U.S.C.A. § 546

(c)(1) Except as provided in Subsection (d) of this Section and in Section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of a the trustee under Sections 544(a), 545, 547, and 549 ~~of this title~~ are subject to ~~any statutory or common law~~ the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller’s business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but—(1) such a seller may not reclaim ~~any~~ such goods unless such seller demands in writing reclamation of such goods—

(A) ~~before 10~~ not later than 45 days after the date of receipt of such goods by the debtor; or

(B) not later than 20 days after the date of commencement of the case, if such 10 day the 45-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor; and

(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in Section 503(b)(9).

~~(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—~~

~~(A) grants the claim of such a seller priority as a claim of a kind specified in Section 503(b) of this title; or~~

~~(B) secures such claim by a lien.~~

1. UCC No Longer Governs

An example may be in order. In *In re Georgetown Steel Company, LLC*,³ the seller of goods was disputing the status of its reclamation claim regarding twelve supersacks of silicomanganes (“SMI”). There, the court determined that reclamation was a state law right, and thus, to prevail, the seller must prove up not only the timely written notice requirement contained in Section 546(c), but also the elements of the state law right: (1) that the goods sold to the debtor on credit were of a type within the ordinary course of business of both parties; (2) that the debtor was insolvent pursuant to the bankruptcy code at the time of delivery of the goods; and (3) that the goods were still in the possession of the goods or that the goods were not in the hands of a good faith purchaser at the time the demand for reclamation was received.⁴ In that case, the seller was unable to prove that the debtor had possession of the goods or that they were not in the hands of a good faith purchaser, thus the seller could not prevail.⁵ The replacement of the words “any statutory or common law” with the word “the” in Section 546(c)(1) appears to change the outcome of this case by rendering the possession requirement moot.

2. Rights of Reclamation as Amended

What if the seller in *Georgetown Steel* had prevailed? Old Section 546(c)(2) gave the court the ability to deny reclamation (i.e. not require the debtor return the goods) where the elements of reclamation were shown if the court granted the seller either a lien in property to secure its claim or granted a priority claim for the value of the goods. The elimination of old Section 546(c)(2) in its entirety seems to divest the court of any option: If the seller shows that the goods were sold within 45 days of the commencement of the case to an insolvent debtor, and that a written demand was timely made, the seller appears to have an absolute right to reclaim the goods. How this will work with the definition of Property of the Estate as described by Section 541 of the Bankruptcy Code and the Automatic Stay provided by Section 362 is yet to be seen. The first instances of litigation may well come when the debtor seeks to sell the goods as part of a larger parcel of goods free and clear of liens and interests pursuant to Section 363.

3. Within 20 Days – De Facto Critical Vendors?

The reality is that in most cases, asset based financing provides a prior perfected lien on most goods such that the right of reclamation is rendered moot. Further, where a lien does not act to moot the reclamation rights, many vendors fail to provide the timely written notice.⁶ So why all the concern about goods sold in the days immediately before the filing? The fact that the right to reclaim, and thus potentially put a serious dent in the debtor’s ability to operate, is one answer. Another answer is found in New Section 546(c)(2) which refers to Section 503(b)(9) which grants administrative expense status for the:

³ 318 B.R. 336 (Bankr.S.C. 2004).

⁴ *Id.* at 339.

⁵ *Id.* At 340.

⁶ Query, however, whether the increased time to provide that notice, and the absence of the requirement that the seller show that the goods are in the possession of either the debtor or an entity that is not a good faith purchaser, taken with the absolute right to reclaim, will increase the instances of reclamation demands.

the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.⁷

This provision, in essence, appears to deem all vendors delivering goods within 20 days of the petition date "critical." Thus, as a result of this provision, it has become increasingly critical that the debtor not order any goods for product lines or stores that will be shutdown at, or immediately after, the filing of the petition which requires additional planning on the part of the debtor and its advisors to avoid unnecessary administrative expenses.

B. Post-BAPCPA Authority

In *In re Tucker*, 329 B.R. 291 (Bankr. D. Ariz. 2005), the bankruptcy court addressed a potential question under the new reclamation provisions codified at Section 546(c). In applying pre-BACPA law, the *Tucker* court evaluated a seller's right to reclaim a vehicle sold to the debtor under the state UCC. In a footnote, the court questioned whether state law UCC analysis still applies under the amended version of Section 546(c). While Section 546(c) previously referred to a seller's right under "any statutory or common law" to reclaim, BAPCPA deletes the reference to statutory or common law, causing the *Tucker* court to query whether new Section 546(c) creates "an entirely new and self-contained body of reclamation law" rather than merely validating (and expanding) rights that exist under the UCC.

II. CREDITORS' COMMITTEE ROLE IN DISSEMINATING DEBTOR INFORMATION

Under BAPCPA, there now exists a new statutory requirement that Creditors' Committees "provide access to information" for creditors under Section 1102(b)(3). Section 1102 provides:

§ 1102. Creditors' and equity security holders' committees

(a) (1) Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.

(2) On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee.

(3) On request of a party in interest in a case in which the debtor is a small business debtor and for cause, the court may order that a committee of creditors not be appointed.

⁷ 11 U.S.C.A. § 503(b)(9).

(4) On request of a party in interest and after notice and a hearing, the court may order the United States trustee to change the membership of a committee appointed under this subsection, if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders. The court may order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern (as described in section 3(a)(1) of the Small Business Act 60, if the court determines that the creditor holds claims (of the kind represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.

(b) (1) A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee, or of the members of a committee organized by creditors before the commencement of the case under this chapter, if such committee was fairly chosen and is representative of the different kinds of claims to be represented.

(2) A committee of equity security holders appointed under subsection (a)(2) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such committee.

(3) A committee appointed under subsection (a) shall—

(A) provide access to information for creditors who—

(i) hold claims of the kind represented by that committee;

and

(ii) are not appointed to the committee;

(B) solicit and receive comments from the creditors described in subparagraph (A); and

(C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

That new section requires official committees to:

- (1) “provide access to information” for creditors holding claims of the type represented by the committee;
- (2) “solicit and receive comments” from the creditors; and
- (3) be subject to a court order that compels “any additional report or disclosure to be made” to the creditors.

As common in the drafting of legislation, Congress left undefined key terms. Among these terms, Congress left for the courts to grapple with the meaning of such basic concepts as the type and amount of “information” that a committee is required to provide to its constituency. Furthermore, Congress left to the courts the obligation to craft a process by which confidential or privileged information should be handled. These procedural deficiencies in the new disclosure obligation have lead astute counsel to seek advice from bankruptcy courts through the establishment of procedures early in the bankruptcy case.

For example, in *In re Refco, Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006), creditors' committee requested relief from the court, seeking to establish a procedure by which information about the debtor may be shared and disseminated to the creditors. Refco, the largest independent U.S. futures brokerage firm, sought relief under the Bankruptcy Code shortly after the disclosure that the company's CEO had secretly incurred \$430 million in debt to the company. After the commencement of the chapter 11 case, the debtors moved to sell their futures business. The United States Trustee appointed a creditors' committee. The committee supported the sale, working with the debtors to establish sale procedures, analyzing potential claims, and instituting an investigation into the financial irregularities that led to the filing. One of the committee's first acts, however, was to seek a clarification of its obligation to share and disseminate debtor information to its constituency. In particular, the committee was concerned that Section 1102(b)(3)(A) might be interpreted as imposing duties contrary to other applicable laws and the committee's fiduciary duties.

In a thoughtful opinion, Judge Drain initially considered the actual language of Section 1102(b)(3). As noted, that section is noticeably silent on key terms and duties, failing to define the "information" that committees must disclose to their constituencies or to describe how such information should be delivered. Next, Judge Drain turned to the legislative history. Remarkably, the legislative history provided no meaningful guidance as to the purpose or intent of the provision short of suggesting that such disclosure requirements were designed for small business debtor cases, a limitation that does not appear in the statute itself. Finding both the statute and the legislative history wanting in guidance, the judge turned to analogous provisions of the existing Bankruptcy Code. In particular, the court noted a long-standing similar requirement for chapter 7 trustees. Under Section 704(7), a trustee must "furnish such information concerning the estate and the estate's administration as is requested by a party in interest" unless the court orders otherwise.

Judge Drain identified three relevant propositions in interpreting a trustee's duties under Section 704(7):

- (1) the duty to furnish information is "fairly extensive" in light of the overriding duty to keep parties informed, with the burden generally being on the trustee to demonstrate why information should not be disclosed;
- (2) the duty to provide information is not unlimited, though, and a trustee can obtain a protective order if disclosure would result in waiver of attorney-client privilege or require disclosure of proprietary or confidential information; and
- (3) the trustee's right to a protective order is informed by the trustee's fiduciary duties, and whether the purpose of the requesting party is inconsistent with those duties (for instance, if the requesting party is seeking information in order to obtain an undue advantage over another party).

In *Refco*, the court observed that all three propositions aided in construing a committee's obligation to provide access to information under new section 1102(b)(3)(A). The *Refco* court also considered any similar practices under the Bankruptcy Act of 1898. Under the 1898 Act, a

committee must “report to the creditors” periodically “concerning the progress of the proceeding.” Construing this obligation under the 1898 Act, courts routinely found that there was no obligation to forward to each creditor “all of the raw data it receives and considers.” Rather, courts generally held that the obligation required a committee to provide a fair presentation of the status of the debtor, so long as there were no material omissions. The *Refco* court Judge Drain found this principle to also apply with equal logic to the “access to information” obligation under Section 1102(b)(3)(A).

Building on the recognized principles under Section 704(7) and prior practice under the 1898 Act, the court confronted the more perplexing issue – the committee’s duties and functions with regard to confidential information. Committees are more than a conduit in the bankruptcy process; in addition to serving as a repository of and clearinghouse for debtor information, the committee negotiates over any proposed plan, provides supervision and oversight over debtors, investigates the debtors’ assets and affairs, and otherwise engages the chapter 11 process as an active participant.

In order to discharge its varied duties, a committee may, either voluntarily or through court order, gain access to confidential or proprietary information from the debtor and others. Regular disclosure of such information could result in a breach of the committee members’ fiduciary duties, possibly violate securities laws if public stock or debt is involved and the disclosure is deemed selective and misleading, and allow competitors access to proprietary information that may put the debtor at a disadvantage. In addition, the court observed that committees have an interest in maintaining confidentiality in order to preserve the committee’s own attorney-client or other privileges, particularly where the committee is authorized to pursue litigation on behalf of the estate generally.

In order to reconcile and balance these concerns, the *Refco* court directed the committee to provide general information to its constituency, but protected the committee from disclosing the following:

- (1) confidential and non-public or proprietary information;
- (2) information which, if disclosed, could result in waiver of attorney-client or other applicable privilege; and
- (3) information which, if disclosed, could violate an agreement, order or law, including applicable securities laws.

The above three categories constitute “protected information.” A committee need not share such protected information absent a court order. However, a committee should consider creditor requests for protected information and should assess whether the requesting creditor would entertain entering into a confidentiality order and/or trading constraints in determining whether otherwise protected information can be disclosed. Finally, the court noted that the judiciary must interject itself actively in any information process, making prompt determinations of any disputes over access to and use of information, in light of the concern that such information may become stale.

Through an order, the court established a “Creditor Information Protocol” or CIP. The CIP provides that the committee will establish and timely maintain a website, accessible by the creditors, that must contain the following information:

- (1) general information concerning the cases, including case dockets, access to docket filings, and identification of significant parties;
- (2) monthly Committee reports summarizing recent proceedings, events and public financial information;
- (3) highlights of significant events;
- (4) a calendar of upcoming significant events;
- (5) access to the claims docket;
- (6) a general overview of the chapter 11 process;
- (7) copies of any press releases issued by the Committee and the Debtors;
- (8) a registration form to request “real-time” case updates by email;
- (9) a form for submitting creditor questions, comments, and requests for specific information;
- (10) responses to such requests (with provision for providing such responses privately in the Committee’s discretion);
- (11) answers to frequently asked questions; and
- (12) links to other relevant websites.

Under the CIP, the committee was presumptively excused from sharing (1) “confidential, proprietary or other non-public information” regardless of source and (2) information if the disclosure would constitute a general waiver of attorney-client, work-product, or other applicable privilege of the committee. The CIP also contemplated that the debtors would assist the committee in identifying confidential information. However, the court noted that to the extent information is obtained by the committee through formal or informal discovery, disclosure would be governed by any discovery order.

However, the court recognized the importance of a dispute resolution process that resolved any disclosure issues in an expeditious manner. Thus, under the CIP, a creditor may seek additional information from the committee, including protected information. After a creditor makes a request, the committee had twenty days (shortened to ten days after January 31, 2006) to respond by either (1) providing the information or (2) giving the reasons why the committee cannot provide the requested information, including any grounds for confidentiality. If the committee determines that information that was originally provided by the debtors (or another entity) on a confidential basis should be provided to creditors, it must give notice to the debtor (or other entity). The debtor or any other entity must then object to any disclosure within 15 days. Although the CIP is designed to force settlement, if the matter cannot be resolved by the parties, the CIP directs the requesting party to move to compel production. Thus, the CIP contemplates continued court involvement.

III. UTILITIES

BAPCPA also amended Section 366, by adding a new subsection (c) that provides additional protections for utilities. Several opinions have addressed the new subsection, leaving much uncertainty as to application and result. For example, in *In re Lucre, Inc.*, 333 B.R. 151 (Bankr. W.D. Mich. 2005), the debtor filed an emergency motion thirteen days after filing its chapter 11 petition, seeking to extend the automatic injunction imposed by section 366(a) to prevent its power company and several telecommunications companies from discontinuing or refusing service. The debtor argued that the injunction should be continued notwithstanding new subsection 366(c) because the debtor made an offer of adequate assurance, and the utilities failed to respond.

As a number of commentators and BAPCPA bloggers have chronicled, Section 366(c) provides a complicated process and timeline. First, under subsection (a), a utility generally may not refuse or discontinue service to a debtor, except as provided under subsections (b) and (c). Second, under subsection (b), a utility may not refuse or discontinue service if within twenty (20) days *after an order for relief*, the debtor furnishes adequate assurance of payment for service after that date. That subsection also provides that, upon request, a court may order a reasonable modification of the amount of the deposit or other security. Third, under 366(c), in a chapter 11 case, a utility may refuse or discontinue service if within thirty (30) days *after the petition date*, the utility does not receive adequate assurance of payment for utility service “that is satisfactory to the utility.” That subsection also provides that, upon request, a court may order modification of the amount of such assurance of payment. Reading subsections (b) and (c) together, one discerns a ten-day gap and a discrepancy in measuring date. How is this inconsistency to be read in light of the move in the BAPCPA to enhance utility protection?

In *Lucre*, the court confronted that discrepancy, initially observing that a debtor’s offer of adequate protection “stands on its own;” thus, the utility had the burden of seeking modification of the offer if it was not satisfied. However, the court refused to consider the Debtor’s request to extend the subsection (a) injunction beyond the 30 days, on the basis that the statute requires “as a condition to continuing the injunction” either the utility’s acceptance of the debtor’s proposed adequate assurance, or the debtor’s acceptance of the adequate assurance proposed by the utility. Thus, a debtor “has no recourse to modify the adequate assurance payment the utility is demanding until the [debtor] actually accepts what the utility proposes.”

But what about the situation where a utility simply refuses to negotiate over the issue of adequate assurance of payment? Although the court acknowledges that new subsection (c) is designed, in part, to preserve and protect the bargaining power of the utility, it does not aid one in understanding whether Section 366 imposes on the utility an implied duty to bargain in good faith before electing to discontinue service. There are several problems with this approach. First, by the nature of the need to find an implied duty, no express duty to bargain in good faith exists in the statute. While such a duty rests on sound policy, that is a decision more appropriate for Congress than the courts. Second, even if one were to conclude that an implied duty exists, what does that mean in this context? Certainly, an implied duty cannot mean that the utility can no longer say no! One approach may center on building a process, similar to labor negotiations, wherein negotiations may take place. However, such an approach is cumbersome and wrought

with abuses. In fact, in the labor context, to make the process work, the paradigm requires an independent administrative body that oversees such negotiations, a process to unwieldy and awkward for our purposes. Third, even if there were clear indications of bad faith negotiation, how would a debtor seek enforcement and prevention of termination? Ostensibly, a debtor may seek to enjoin the utility from terminating service. However, an injunction would require the commencement of an adversary proceeding under the Bankruptcy Rules and a ruling from the court within thirty (30) days. Thus, early in a case, a debtor may be put to the test at great expense and effort to preserve a utility service.

In *Lucre*, the court also addressed a fascinating issue of statutory construction – under new subsection (c), are all utilities equal? The court, reading the plain language of that subsection, concluded that not all utilities are treated equally. The court correctly noted that in subsections (a) and (b), Congress used the term “service,” while in subsection (c), Congress employed the term “utility service.” The court held that this distinction indicated Congress’ intent that new subsection (c) only applies to utilities that provide services that *the debtor itself actually consumes*. In *Lucre*, however, two of the utilities provided wholesale telecommunications services that were purchased by the debtor but passed on to its own customers. The court held that these utilities did not provide “utility service” to the debtor within the meaning of subsection (c). Thus, these utilities were not entitled to the more demanding requirements of subsection (c).

In *In re Astle*, 338 B.R. 855 (Bankr. D. Idaho 2006), a chapter 12 case, the court further limited the application of subsection (c). The court held that the more demanding requirements of adequate assurance required under new Section 366(c)(1)(A) apply only to chapter 11 cases. Thus, under *Astle*, pre-BAPCPA law continued to govern the assurance of payment that a chapter 12 debtor must provide to secure continuity of utility service.

IV. LEASE CAPS AND LEASES

A. Leases – Analyze Early

In the case of *In re Hechinger Investment Company of Delaware, et. al.*⁸ on the June 11, 1999 petition date, the debtors had in excess of 260 leases and subleases of nonresidential real property. Through a series of motions, the time to assume or reject these leases was extended, over objection from landlords, until June 1, 2000, approximately 1 year later.⁹ In the case of *In re Montgomery Ward, LLC, et. al.*¹⁰ when the case was filed on December 28, 2000, the debtor had approximately 300 non-residential real property assets. On January 24, 2002, in a motion for a further extension of time to assume and reject until August 31, 2002, the debtor reported that

⁸United States Bankruptcy Court for the District of Delaware Case Number 99-02261.

⁹Revised Disclosure Statement for Revised First Amended Consolidated Plan of Liquidation, *In re Hechinger Investment Company of Delaware, et. al.*, Case Number 99-02261, United States Bankruptcy Court for the District of Delaware, page 22.

¹⁰United States Bankruptcy Court for the District of Delaware Case Number 00-4667.

137 leases had been rejected, 30 had been terminated, and 51 had been assumed and assigned.¹¹ Of course, like in the *Hechinger* case, this had taken over a year and they still needed more time. While the confirmation of a plan made the motion for additional time in *Montgomery Ward* moot, these cases are indicative of the length of time it historically took to fully analyze leases in a large retail bankruptcy. Because of the 2005 Act's amendment to Section 365(d)(4),¹² debtors will no longer have the luxury of such time. Where there use to be years, now, without the consent of the landlord, the maximum time is 210 days from the order for relief – the initial 120 days provided by Section 365(d)(4)(A) and the possible additional 90 days provided by Section 365(d)(4)(B). Any extension of time past the 210 days, will require the consent of the landlord; which, in turn, will most like require the payment of a “consent fee.”

Professor Ken Klee suggests one other possible outcome – retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into involuntary cases. The “gap period” created by the involuntary case will create additional time to analyze the leases during periods of greater sales activity.¹³

In exchange for the reduction in the period by which a lease may be assumed or rejected, Congress provided a cap on damages associated with a post-assumption termination or breach. Under pre-BAPCPA law, a post-assumption breach gave rise to an administrative expense for all damages resulting from the breach without resort to any cap on damages. These courts held that Section 502(b)(6) applied to prepetition/pre-assumption claims only. Under BAPCPA, any post-assumption breach is now capped at two years “obligations.”¹⁴ Note, that while “obligations”

¹¹ *In re Montgomery Ward, LLC et. al.*, Motion for Order Under 11 U.S.C. §§ 105, 365(d)(4) and Fed. R. Bankr. P. 9006 (I) Authorizing Extension of time Within which Debtors May Assume or Reject Unexpired Leases of Nonresidential Real Property and (II) approving Extension of Kimsward, LLC's Designation Rights, Docket Number 2577, p. 5.

¹² §365(d)

~~(4)(A) Notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60 day period, fixes, then such lease is~~ Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender such that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.
- (B) (i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120- day period, for 90 days on the motion of the trustee or lessor for cause.
- (ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

¹³ Klee, Kenneth N., *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 – Business Bankruptcy Amendments*, www.ktblaw.com/publications/Business%20Bankruptcy%20Amendments202005.PDF.

¹⁴ 11 U.S.C. § 502(b)

~~(7) with respect to a nonresidential real property lease previously assumed under section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be~~

seems to imply more than straight rent, penalties arising from “failure to operate” clauses or other penalty provisions are expressly excluded.

B. Lease Caps and Deposits

As we have seen above, there is now a cap on the damage claims arising from both leases that are rejected and those that are assumed but later rejected. But how are those damages calculated, particularly when the landlord holds a letter of credit as security? In *AMB Property, L.P. v. Official Creditors (In re AB Liquidating Corp.)*,¹⁵ the parties agreed that the gross damages were \$5 million, that capped damages were one year’s rent of \$2 million pursuant to section 502(b)(6), and the landlord held a letter of credit in the amount of \$1 million as security. The creditors asserted that the letter of credit should reduce the capped damages to \$1 million while the landlord asserted that the letter of credit, like any other form of mitigation, should be applied to the gross number. The Ninth Circuit held that the letter of credit should be applied to the capped damages pursuant to a 1944 Second Circuit case, *Oldden v. Tonto Realty Co.*,¹⁶ a case cited favorably in the legislative history. In *AMB*, the landlord had asserted that *Oldden* was wrongly decided and should not be followed because the plain language of section 502(b)(6) required that the letter of credit be applied to the gross damages just as the proceeds from releasing the property or other forms of mitigation would be applied. In siding with the creditors, the court found that the plain meaning of the statute did not give any indication of how a letter of credit should be treated, so the legislative history, which cited *Oldden*, had to be consulted. Thus, the capped claim amount of \$2 million had to be reduced by the \$1 million proceeds from the letter of credit.

AMB seems to assume that the landlord creditor filed a proof of claim to which the debtor (or a creditor) objected. But what if the letter of credit exceeded the capped amount, and, therefore, the landlord creditor did not file a proof of claim? What if, instead, the issue of the cap came up when the debtor sought to recover the amount of the letter of credit in excess of the capped damages? That issue was one of the questions addressed by the Fifth Circuit in *EOP-Colonnade of Dallas LP v. Faulkner (In re Stonebridge Technologies, Inc.)*.¹⁷ There, the court began with the proposition that, due to circuit precedent, the proceeds from a letter of credit were not property of the estate. Thus, the landlord creditor did not need to file a proof of claim after providing the required notice and drawing down on the letter of credit. Claims under section 502(b) do not automatically arise with rejections, a proof of claim is required. The court then determined that the cap on damages in section 502(b)(6) requires two factors for applicability: (1) a lease rejection giving rise to damages and (2) a claim against the estate. In holding the cap inapplicable, the court reasoned that because the draw on the letter of credit was not a “claim against the assets of the estate,” the requirements for the implementation of the cap were not met. In response to the debtor’s argument that the letter of credit was part of a security deposit under the lease and thus within the purview of section 502(b)(6), the court determined to so hold would be to imply an avoidance power not in the statute and where the Bankruptcy Code intends an

received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6);

¹⁵ 416 F.3d 961 (9th Cir. 2005).

¹⁶ 143 F.2d 916 (2nd Cir. 1944).

¹⁷ 430 F.3d 260 (5th Cir. 2005).

avoidance power, it is clearly stated, not implied. Thus, the debtor could not recover the proceeds of the letter of credit in excess of the amount that would be allowable under the cap in section 502(b)(6). Note, however, that this case leaves open the question of what would happen if the landlord creditor filed a proof of claim before realizing that the letter of credit exceeded the allowable amount.

What can we conclude from these cases? First, if a landlord creditor holds a letter of credit in excess of the amount allowable under the cap provided in section 502(b)(6) – and presumably the cap provided under section 502(b)(7) as well - that landlord creditor should take the steps necessary to draw down on the letter of credit and should not file a proof of claim. However, if the amount of the letter of credit is less than the amount provided by the cap, the proceeds from the letter of credit, at least in section 502(b)(6) instances, will reduce the capped amount recoverable rather than the gross amount. Whether the same application of the proceeds of letters of credit will hold true in section 501(b)(7) cases is yet to be seen.