LANDLORD ALERT: LIMITATIONS ON STRATEGIC BANKRUPTCY FILINGS BY "HEALTHY" COMPANIES TO CAP LONG-TERM LEASE OBLIGATIONS

Insolvency and Restructuring November 8, 2004

Summary

Under Section 502(b)(6) of the Bankruptcy Code, Chapter 11 debtors have a very powerful statutory tool to limit a landlord's recovery under a long term real property lease when the lease is rejected in bankruptcy. Generally, under Bankruptcy Code Section 502(b)(6), a landlord's claim for damages resulting from the termination of a real property lease will be limited to the obligations due under the lease for the greater of (i) one year or (ii) fifteen percent, not to exceed three years, of the remaining term of the lease, plus amounts due under the lease on the earlier of the bankruptcy filing date or the date the property was surrendered. However, two recent judicial decisions, one by the Third Circuit Court of Appeals and the other by a California bankruptcy court, clarify that a lessee may be denied the ability to remain a Chapter 11 debtor when it is solvent and files for bankruptcy relief as a strategic maneuver solely to reject a lease and limit a landlord's lease recovery. Knowledge of this evolving caselaw may impact your ability to protect your rights in certain situations.

In re Integrated Telecom Express

At the time of its Chapter 11 bankruptcy filing on October 9, 2002, Integrated Telecom Express, a supplier of software and equipment to the broadband communications industry, had sufficient cash to pay all creditors in full and had ceased all operations. Prior to that time, while in the process of liquidating its assets, Integrated was unable to negotiate an agreement with its landlord to reduce Integrated's remaining obligations under its long-term real property lease to $8 million instead of $26 million. Thereafter, Integrated filed for Chapter 11 relief in the United States Bankruptcy Court, District of Delaware. The landlord filed a motion to dismiss Integrated's Chapter 11 case as a bad faith bankruptcy filing on the grounds that the sole reason for the filing was to use the limits imposed by Bankruptcy Code Section 502(b)(6) of the Bankruptcy Code to cap the landlord's approximately $26 million rent claim at $4.3 million.

The Delaware bankruptcy court denied the landlord's motion to dismiss the bankruptcy case, citing Integrated's "dramatic" financial losses and noting that Integrated offered a number of reasons for the bankruptcy filing. The denial of the motion was upheld by the U.S. District Court. On further appeal, the Third Circuit Court of Appeals overruled the District Court in In re Integrated Telecom Express, 384 F.3d 108 (3rd Cir. 2004). In the Integrated Telecom decision, which relied heavily on its previous decision in In re SGL Carbon Corp., 200 F.3d 154 (3rd Cir. 1999), the Third Circuit found that notwithstanding Integrated's financial problems, Integrated was still solvent at the time of its bankruptcy filing. The Third Circuit focused on the fact that Integrated's cash on hand was sufficient to meet all of its debts, and held that to be filed in good faith, a bankruptcy petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code, but must seek to create or preserve some value that would otherwise be lost – not merely distributed to a different stakeholder – outside of bankruptcy. Of stated concern to the Third Circuit in the Integrated

Telecom decision was the fact that the Court could not identify any value for Integrated's assets that was being threatened outside of bankruptcy by the collapse of Integrated's business model, but that could be preserved or maximized in an orderly liquidation under Chapter 11.

In the Integrated Telecom decision, the Third Circuit also responded to Integrated's argument that the bankruptcy forum was appropriate to resolve the landlord's claim by stating that "[t]aken to its logical conclusion, the ... argument is that any entity willing to undergo Chapter 11 proceedings may cap the claims of its landlord. Nothing in the Bankruptcy Code or its legislative history suggests that § 502(b)(6) was meant to allow tenants to avoid their leases whenever the landlord's state law remedy exceeds the cap ... by an amount greater than the cost of proceeding through a Chapter 11 reorganization or liquidation." Integrated Telecom, 384 F.3d at 129.

In re Liberate Technologies

Liberate Technologies, a developer and licensor of software used by cable television companies for providing video-on-demand services and high-definition television, filed for bankruptcy relief in the United States Bankruptcy Court in Delaware on April 30, 2004.[1] Although Liberate's business had not been successful, and at the time of its bankruptcy filing Liberate had approximate total liabilities of between $59 million and $167 million (including estimated litigation liability), Liberate held $212 million of unrestricted cash remaining from its 1999 initial public offering and secondary financing. In addition, at the time of its bankruptcy filing Liberate had recently received an offer from a third party to purchase Liberate's assets in a stock transaction, by which Liberate would have ceased its operating losses, sold its business as a going concern and retained at least $130 million in cash and the purchaser's stock to distribute to Liberate's shareholders.

As part of its pre-bankruptcy efforts to reduce expenses, Liberate vacated and surrendered its leased office space to its landlord, Circle Star Center Associates, L.P. Notwithstanding the surrender, under applicable state law, Liberate remained liable to Circle Star for total future rent due under the lease of approximately $45 million. After the bankruptcy filing, Liberate "rejected" its lease with Circle Star and, on May 17, 2004, Liberate filed its Chapter 11 plan of reorganization, under which it proposed to reduce Circle Star's claim to $8 million pursuant to the cap on future rent claims imposed by Section 502(b)(6) of the Bankruptcy Code. Based on this treatment, Circle Star filed a motion to dismiss Liberate's bankruptcy case as having been filed in bad faith.

In determining the merits of Circle Star's request to dismiss Liberate's bankruptcy case, the bankruptcy court in In re Liberate Technologies, 314 B.R. 206 (Bankr. N.D. Cal. 2004), focused on the standards enunciated by the Third Circuit in the SGL Carbon decision and by the Ninth Circuit in In re Marsch, 36 F.3d 825 (9th Cir. 1994), that (i) a present need for bankruptcy relief is a central element of good faith, and (ii) a solvent entity generally has need for bankruptcy relief only to avoid liquidation of its business assets. With those standards as the starting point, the Liberate Court analyzed the following factors:

[1] The case was transferred to the United States Bankruptcy Court in the Northern District of California on May 12, 2004, upon the Delaware Bankruptcy Court's order granting a motion to transfer venue.

- Pending Litigation. Of the five significant actions against Liberate, Liberate expected to settle two, and another had only insignificant potential liability. Further, it was possible that the litigation would result in less liability than the estimated maximum liability, and, in any event, Liberate had sufficient cash to satisfy all judgments in full – it was not threatened with having to litigate its business assets to satisfy a judgment.
- Lack of Profitability. If Liberate were to incur projected losses of $32 million in the next year and suffer adverse judgment in its pending litigation, Liberate might not have sufficient assets to pay its creditors in full. However, the Liberate Court determined that this fact did not establish or support a present need for bankruptcy relief since Liberate may incur no or reduced liability in the pending litigation, its operating losses may be not as high as estimated, and, if Liberate's business assets are sold, Liberate will cease incurring operating losses and will receive tens of millions of dollars.
- Claim for Future Rent. As to Liberate's ability to utilize Section 502(b)(6) to limit Circle Star's lease recovery, the Liberate Court reiterated the principle that a debtor must have a present need for bankruptcy protection before it may invoke any of the various provisions of the Bankruptcy Code enacted by Congress to aid financially troubled companies.
- Sale of Assets. Although Liberate stated its desire to sell its assets under the protections of the Bankruptcy Code as a reason to remain under Chapter 11, the Liberate Court found that Liberate's concerns for selling its assets in bankruptcy (to obtain the good faith buyer protections of Section 363(f) and to use a stalking horse bidder to obtain higher offers) went only to how much Liberate could return to its shareholders, not to whether Liberate could pay its creditors or sell its assets as a going concern.
- Other Considerations. In ruling that the principal reason to dismiss Liberate's case was the lack of need for bankruptcy protection, the Liberate Court noted that the proposed plan of reorganization did not offer any scenario for a genuine rehabilitation of the business (the plan even provided that Liberate might sell its business post-confirmation).

Based on this analysis, the Court dismissed the Liberate bankruptcy case on September 8, 2004 because it found Liberate to be "very" solvent and "very" liquid, and because Liberate could sell its assets as a going concern. [2]

What This Means To You.

In practice, the impact of the Integrated Telecom and Liberate Technologies decisions is that landlords should carefully scrutinize Chapter 11 bankruptcy filings by their tenants. Where the debtor is financially solvent and the bankruptcy filing appears to be made for a sole strategic purpose of eliminating or reducing long term lease obligations, dismissal of the bankruptcy case may be a viable recourse for the landlord.

---

[2] As of the date of this Client Alert, the Debtor in the In re Liberate Technologies bankruptcy case has appealed the Bankruptcy Court's September 8, 2004 Order dismissing the case.

Further Information

If you would like more information regarding this Client Alert or other insolvency or creditors' rights issues, please contact us. We are glad to discuss any questions you may have on this or other insolvency matters.

Craig A. Barbarosh
Orange County Office – 714.436.6822
cbarbarosh@pillsburywinthrop.com

Karen B. Dine
New York Office – 212.858.1791
kdine@pillsburywinthrop.com

M. David Minnick
San Francisco Office – 415.983.1351
dminnick@pillsburywinthrop.com

Mark D. Houle
Orange County Office – 714.436.6843
mhoule@pillsburywinthrop.com

This publication is issued periodically to keep PILLSBURY WINTHROP LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of special interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.