An aerial photograph of a port terminal. In the center, two large, white, cylindrical storage tanks are visible. To the right, a large cargo ship is docked at a pier, with its deck and superstructure clearly visible. The terminal area is filled with various pieces of equipment, including cranes and containers, and is surrounded by roads and parking lots. The overall scene depicts a busy port facility.

American Association of Port Authorities
Planning for Financial Downturns and
Bankruptcy

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Fact Pattern



Facts: The port has a lease with ABC Corporation. ABC is actually a subsidiary of XYZ holding company. The port has 3 months of lease security under a letter of credit issued by Washington Mutual. There are rumors that XYZ is getting ready to file for Chapter 11 bankruptcy.

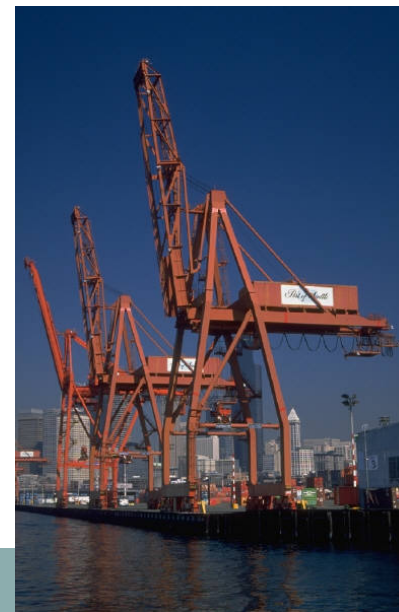
Questions:

1. What should the port do?
2. Is our lease security safe? How can we improve our situation in the future? What should we provide in our other leases?

Issue Spotting



- 1) Filing for bankruptcy.
- 2) Executory contracts: assumption, rejection, and assignment.
- 3) Relationship between tenant and bankrupt parent.
- 4) Lease security.
- 5) Letters of Credit.
- 6) Financial strength of surety.



First Issue: Bankruptcy



- Chapter 7: Liquidation
- Chapter 11: Reorganization
- Immediate Effects of Bankruptcy
- Creation of Estate
- Claims

Immediate Effects of Bankruptcy Filing:



Automatic Stay §362(a)

- Bars contractual enforcement actions against debtor after filing.
- This means a landlord cannot terminate a lease or request specific performance
 - Exception: stay does not apply to actions to recover possession of the leased premises if the lease is terminated prior to the Petition Date.

All creditors must file claims directly to the bankruptcy court or be held in contempt.

First Day Motions

- Watch out for: motion to establish administrative bar date, motions to subordinate claims, and blanket procedural motions.

Creation of the Bankruptcy Estate



Estate

- Created by filing petition consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. §541(a)(1).
 - Includes all tangible and intangible property, and causes of action.

Trustee

- Generally debtor chooses trustee of estate, but may allow United States to act as trustee.

Filing divides the history of the debtor into two time periods:



1) Prepetition

- Defaults on rent prepetition are treated general unsecured claims
- Unsecured creditors are on the bottom rung of the bankruptcy food chain

2) Post petition

- If tenant retains possession of land after filing, the debtor is obligated to pay rent for that time.
- Administrative expense = priority accorded payment of fees and expenses of the debtor's attorneys, accountants, and advisors.

Landlord Claims



- Claim defined broadly as a “right to payment,” even if contingent or unliquidated. §101(5)(A)
- Must be filed before bar date.
- Prepetition claim:
 - Unpaid rent or other damages
- Post petition claims:
 - Debtor obligated to pay rent and taxes under lease arising after the filing date, any unpaid rent is an administrative claim.
- Post rejection claim:
 - Future rents or other damages tied to possible rejection of lease
 - Claim includes all damages allowed under lease and state law
 - General unsecured non priority claim



Issue Two: Executory Contracts

- §365 governs the treatment of “executory” contracts and leases in bankruptcy:
 - One of the most frequently litigated sections of the Code, case law varies from circuit to circuit.
- What is an “executory contract”?
- Assumption, Rejection, and Assignment of Lease
- Time Frame for Assumption/Rejection
- Landlord and Tenant Obligations

What is an executory contract?



- Not defined under the Code but case law has defined a contract as executory if:
 - Both parties still owe performance at the time of the bankruptcy filing, and
 - The obligations of both parties are so far unperformed that the failure of either party to complete performance would result in a material breach.
- Non-residential real property leases.



Assumption, Assignment, and Rejection



- **Debtors have unilateral right to choose to:**
 - Assume the contract or assign the contract to a third party; OR
 - Reject the contract, treated as a breach as of the day before the Petition Date.
- **Court approval, but deference given to debtor's "business judgment"**
- **Assumption is all or nothing, there is no partial assumption.**

Time frame for assumption

- Debtor must continue to timely perform all obligations under the lease. §365(d)(3).
- 2005 amendments limits timeframe to 120 days with 90 day extension for cause – further extensions require written landlord consent.
 - Before 2005, Debtor had 60 days with unlimited amount of extensions.
- May be in the best interest of the port to allow debtor the time it needs.



How does assumption of the lease affect the Port?



For the Port:

Rent considered an administrative expense under §503(b)(1)(A), meaning claims for rent are paid prior to general unsecured creditors.

- **Specific Performance available as a remedy.**
- **Debtor must cure all defaults upon assumption.**

Tenant obligations with assumption:



- **Tenant must:**
 - cure any defaults (such as failure to pay rent),
 - pay any damages resulting from debtor's prior breaches, and
 - provide adequate assurance of future performance. §365(b)(1)

Port must object to cure amount promptly.

Rejection?



- Notice to Port required.
- Rejection date ends landlord's right to current rent payments.
- Landlord's rejection claim consists of:
 - 1) General unsecured claim for any unpaid prepetition rent or damages (including attorney fees) – no cap.
 - 2) General unsecured post rejection claim for future rents and other damages
 - Rejection damages §502(b)(6)
 - Rent from date of filing through natural term of lease
 - Capped at one year or 15% of rent

Landlord's cap for rejection damages under §502(b)(6)(A):



- **Cap is the greater of:**
 1. Limited to 15% of the remaining rent due (not to exceed three years), or
 2. One year's rent.

Note that pre-petition lease obligations are not subject to cap, only post-petition, future rent obligations.

Issue Three:

ABC is a subsidiary of XYZ



- How will XYZ's bankruptcy effect ABC?
- Often parent and subsidiaries will file petition in same proceeding.
- If only parent files:
 - Parent XYZ's ownership interest in ABC means ABC does form part of XYZ's bankruptcy estate.
 - ✦ This does not give parent direct interest in subsidiary's *assets*.
 - ✦ Distinction between parent's interest in subsidiary and parent's interest in subsidiary's assets.

Bankruptcy Court's Jurisdiction over ABC



- **Jurisdiction:**

- ✦ Bankruptcy court's jurisdiction does not extend to wholly owned subsidiaries of the debtor, unless subsidiary is a mere sham or conduit rather than viable entity. *In re Stein & Day, Inc.*, 113 B.R. 157 (1990)

Does automatic stay apply to ABC?



- **Automatic Stay:**
 - Generally only applies to the debtor
 - Exception for “unusual circumstances”
 - ✦ Such as where there is such identity between the debtor and third-party defendant that judgment against third-party will in effect be a judgment or finding against debtor. *Kreisler v. Goldberg*, 478 F.3d 209 (4th Cir. 2007).

Issue Four: Lease security



- **Purpose of lease security?**
 - 3 months of lease security for ABC.
 - Generally landlords require one year's worth of rent.
- **Common forms:**
 - Letter of credit
 - Cash
 - Bond
 - Guarantee
- **§541(a): generally security deposit is an asset of the bankruptcy estate**

Issue Five: Letter of Credit



- **Letter of credit**
 - Preferable over cash deposit because cash is considered part of debtor's estate

LCs are governed by Article 5 of the UCC

Basic Mechanics

Independence Principle

LCs and Landlord Cap on Damages

Basic Mechanics of Letter of Credit



Three parties:

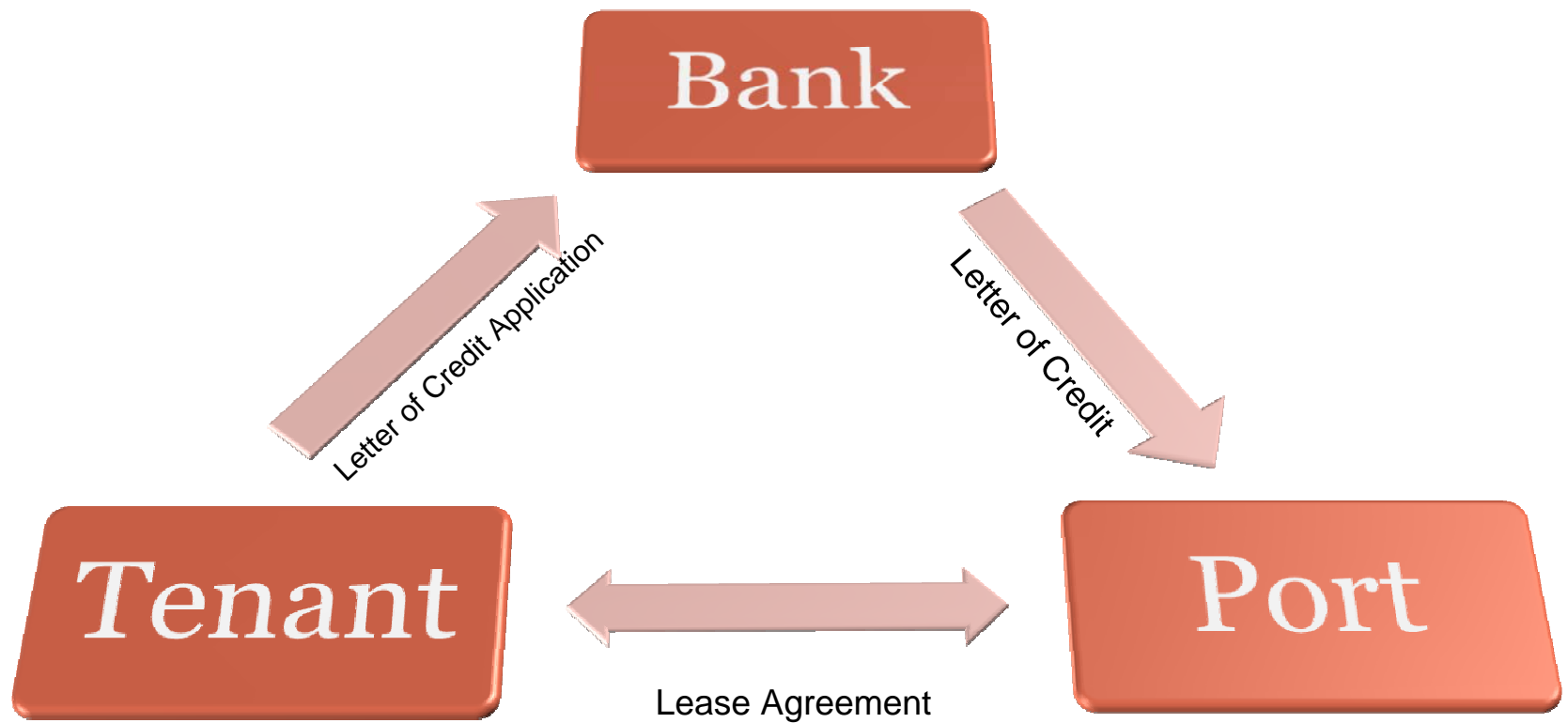
- 1) Applicant
- 2) Beneficiary
- 3) Issuing Bank

Three contracts:

- 1) Contract of Payment
- 2) Letter of Credit Application
- 3) Letter of Credit

Letters of Credit are documentary and independent of any other contract or obligation.

How Letters of Credit Work



Independence Principle



- **Common law protection:**
 - ✦ A letter of credit is an independent third-party obligation and the proceeds are not the debtor's property, even if secured by the debtor's property.
- **Means that automatic stay does not extend to the draw-down of a letter of credit.**
 - ✦ Payment in 100 cent dollars!
- **However, once landlord has the proceeds a bankruptcy court may require the landlord to return a portion of the proceeds to the debtor's estate.**
- **Lease provisions related to letter of credit must be carefully drafted.**
 - Do not make drawing of funds contingent upon any events or circumstances within any third party's control.
- **LC language should be specific:**
 - No generic LCs, LCs must be assigned specifically to the current landlord
 - LCs should state that a draw can be made if the landlord submits the original LC with, at most, a short signed note stating that the tenant has defaulted under the lease.

Statutory Cap on Damages and LCs



- Split in case law on issue of whether letter of credit must be applied in reduction of cap.
- 1) LC can only be used up to the amount of the statutory cap and any amount greater than that cannot be drawn.
 - 2) Landlord can draw full amount of LC, even if greater than statutory cap, if landlord does not file proof of claim.

Relevant Cases:



In re PPI Enterprises, Inc., 324 F.3d 197 (3rd Cir. 2003).

- ✦ *Because case law establishes that security deposits are applied to capped claims, and LC was intended to be used a security deposit, the LC can only be drawn up the amount of the capped claim.*

In re Stonebridge Technologies, Inc., 430 F.3d 260 (9th Cir. 2005).

- ✦ Landlord's retention of letter-of-credit proceeds in excess of the bankruptcy cap on a landlord's damages was permissible because the cap was not triggered where the landlord did not file a claim in the tenant-debtor's bankruptcy case.

Oldenn v. Tonto Realty Corp., 143 F.2d 916 (2nd Cir. 1944).

- ✦ Security deposit counts towards total claim of a landlord.

Musika v. Arbutus Shopping Center Limited Partnership, 260 B.R. 10 (2001).

- ✦ Court held that neither letter of credit nor its proceeds were property of the tenant's bankruptcy estate.

In re Sabratek Corp., 257 B.R. 732 (2000).

- ✦ Court denied debtor's attempt to obtain a preliminary injunction preventing landlord from drawing down letter of credit.

In re Prime Motor Inns, Inc., 130 B.R. 610 (1991).

- ✦ Bankruptcy court has no jurisdiction to issue an injunction enjoining payment of a contract not involving the debtor.

Issue Six: Financial Strength of Surety



- **Insolvent Bank?!?**
- **If FDIC takes over it may disaffirm all LCs.**
 - Courts have held FDIC can't do this – FDIC is responsible for exposure and must make beneficiaries whole
- **WaMu bought up by Chase, therefore Chase has the obligation to make LC beneficiaries whole.**
- **If the bank had been liquidated, beneficiaries would have ratable claim.**
- **Landlords should only accept LCs from issuers with a strong credit rating and should attempt to secure a local bank to expedite drawing funds if necessary.**

Kaiser Aluminum & Chemical Corporation Bankruptcy



- The Port of Tacoma had a Lease and Operating Agreement with Kaiser Aluminum & Chemical Corporation (“Kaiser”). The Port had lease security in the form of a bond.
- Kaiser Group filed for Chapter 11 bankruptcy on February 12, 2002.



Kaiser Operations



Two facilities at the Port:

1) Leased Portion: 10-acre terminal facility.

2) 96-acre smelter on the Blair-Hylebos Peninsula owned by Kaiser (mothballed prior to bankruptcy).



Kaiser Bankruptcy and Lease Termination



- **Port filed a proof of claim for amounts owing under both the Lease and the Operating Agreement.**
 - Included charges accrued both before and after the Petition Date.
 - Kaiser continued to pay rent after Petition Date, lowering the amount of the Port's claim for unpaid rent.
- **Settlement Agreement for Lease Termination**
 - Kaiser agreed to lift the automatic stay to allow the Port to collect from the Surety secured by the Lease Security Bond.
 - Anything unpaid would be a general non-priority claim.

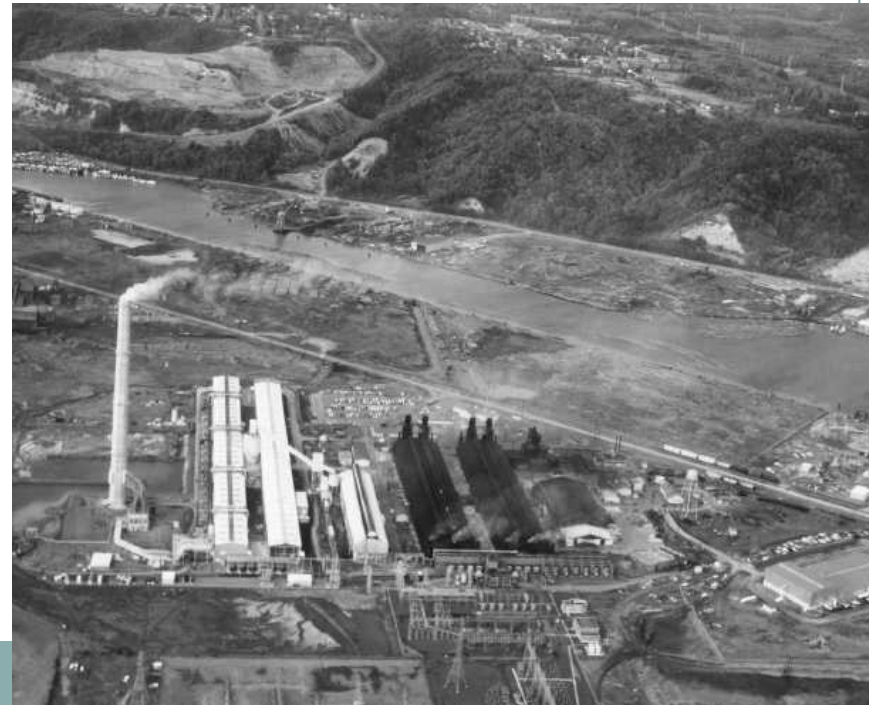
Impact of the Kaiser Bankruptcy for the Port



Concern by the Port regarding future use of the smelter facility.

- Impact of bankruptcy for the Port's future development plans.

The Port took a more global view of the bankruptcy plan, and decided to acquire the 96-acre former smelter.



East Blair Waterway



Environmental Liability



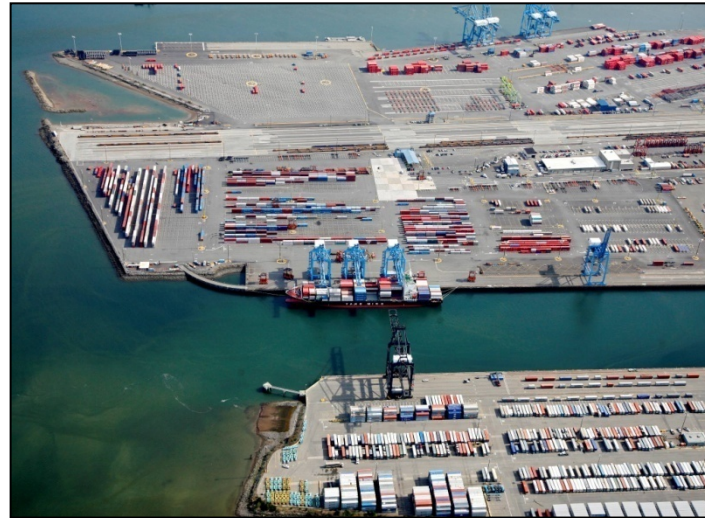
- **Environmental concerns with purchase of the property:**
 - Part of the Commencement Bay Superfund Site
- **Terms in the PSA:**
 - Established fair market value of the property.
 - Subtracted agreed upon remediation costs.
 - Escrow funds set up for un-agreed upon environmental costs.



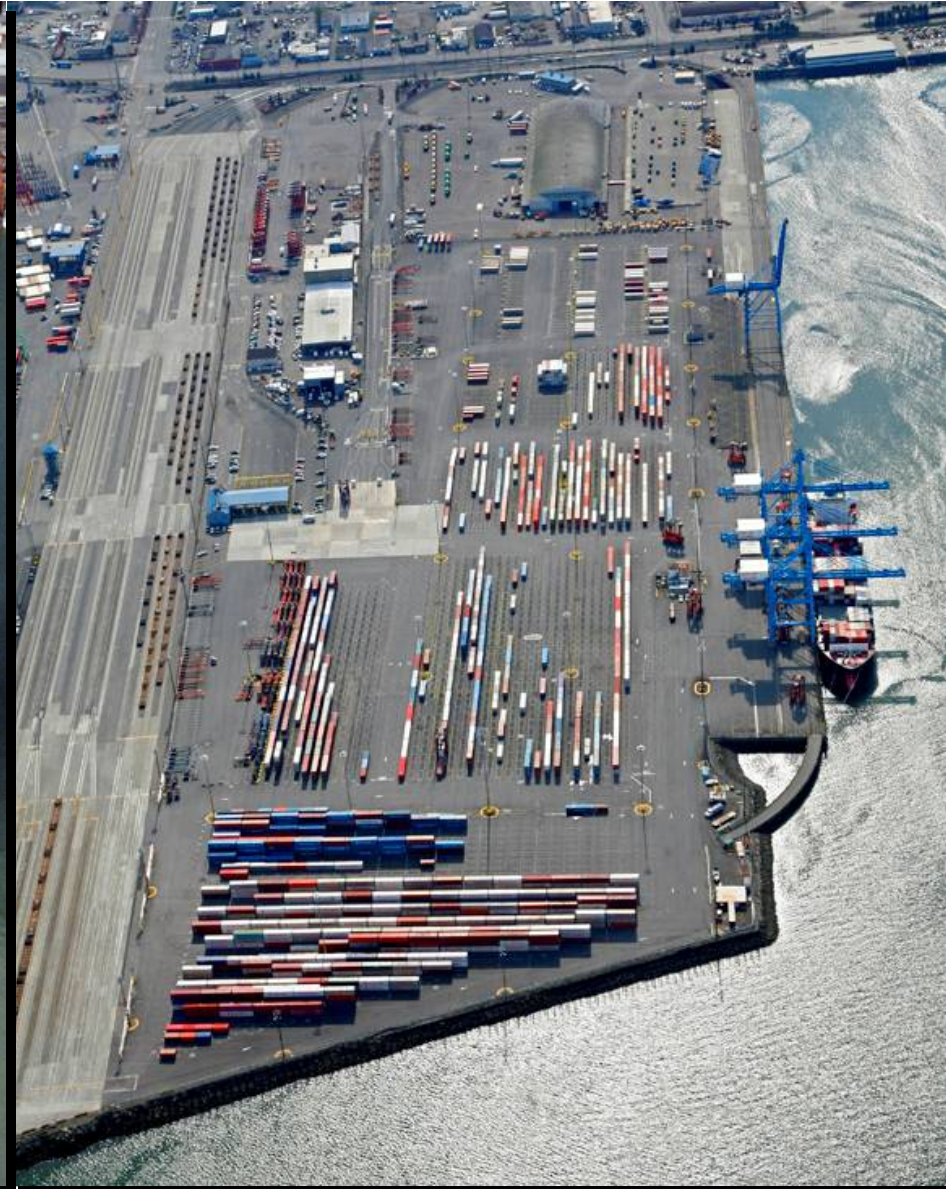
Positive Outcomes for the Port of Tacoma:



- **The material around the domes was used to fill Slip 1 and create a new terminal facility.**



➤ Port was able to sell product inside the domes once the metals market recovered and upon removal was able to integrate this property into a container terminal.





Port was able to transform the former smelter....



...into a new terminal facility.

How can a Port's prepare for similar situations in the future?



- **Consider carefully the viability of future tenants:**
 - Established track record of business?
- **Consider lease provisions carefully:**
 - Consider common area infrastructure (CAI) and common area maintenance (CAM) charges.
 - Environmental provisions
 - Assignment issues
 - Acceleration clauses
 - Lease security

Lease provisions that can help protect the Port:



Environmental Protection:

- Compliance with applicable laws with periodic review and amendments to remain current.

Assignment and Subletting:

- Port interest in controlling type of tenant and activities.
- Assignments provide possibility for financial gain to all participants.

What should the Port provide in future leases?



- **Include an acceleration clause which will permit a draw equal to the entire remaining amount due under the lease, not just enough to cover the current amount of tenant's unpaid rent.**
- **Maximize landlord's right to draw down and retain the proceeds of a letter of credit for lease defaults and/or tenant bankruptcy**

Example of Acceleration Language:



- **Remedies.** Upon occurrence of any default by Lessee, Lessor shall have the option, without any notice or further demand, to terminate this Agreement, or to relet the Premises and receive the Rental and Preferential Use Fee for the Premises, in which event Lessee shall immediately surrender the Premises to Lessor, and Lessee shall pay to Lessor on demand the amount of all loss and damage which Lessor may suffer by reason of such termination or subletting. In either event, Lessor may recover all loss and damage from Lessee on a month by month basis, or may accelerate all loss and damage and amounts due under Agreement for the remainder of the term, but upon acceleration all loss, damage, and amounts due under this Agreement shall be discounted to present value using discount rate appropriate at such time. Pursuit of any of the foregoing remedies shall not preclude pursuit of any other remedies available in law or equity, nor shall pursuit of any remedy provided herein constitute a forfeiture or waiver of any rent or other amounts due to Lessor under this Agreement or of any damages accruing to Lessor by reason of the violation of any terms, provisions, or covenants of this Agreement. In the event of a default by Lessee, Lessor shall have the duty to mitigate damages.

Example of a lease security provision:



- **Lease security.** Effective from and after the Commencement Date Lessee shall at all times maintain in effect and on file with Lessor security in an amount equal to the total of one (1) year of total Rental and Preferential Use Fee (estimated upon execution of this Agreement to be \$_____USD), in the form of cash, a bond, bank guarantee, or letter of credit issued or confirmed by a United States bank or financial institution doing business in _____ and reasonably acceptable to Lessor, or a blocked account held in such financial institution or in another form reasonably satisfactory to Lessor. The security shall be conditioned to guarantee Lessee's performance of all terms of this Agreement, in a form reasonably acceptable to Lessor. The amount of such security shall be adjusted on the fifth (5th) anniversary of the first January 1 following Commencement Date and every five (5) years thereafter as a result of rental and other adjustments pursuant to this Agreement or any amendments thereto, and as a result of any other changes affecting the value and/or term of this Agreement, made during the preceding five (5) years. A draft of the initial security required herein, and all changes thereto or replacements thereof, shall be filed with Lessor at least ten (10) days prior to the Commencement Date of this Agreement, the effective date of any change or extension of the term of this Agreement, or the termination date of any security to be replaced, whichever is applicable, and the actual security shall be filed with Lessor on or before the Commencement Date, effective date, or termination date, as the case may be. If Lessee shall fully and punctually comply with all terms of this Agreement, the security shall be promptly returned or released with Lessee within one hundred twenty (120) days after the expiration or earlier termination of this Agreement and delivery of exclusive possession of the Premises to Lessor.

Lease Security Provisions



- Underlying lease should permit Port to determine form of lease security:
 - Port should have right to require 3rd party guarantee as additional collateral
- Be clear LC secures all claims under the lease, both monetary and non-monetary.
- Provide short time periods for cure in the case of default, perhaps even automatic termination with certain kinds of default, and be clear the Port may draw on the LC in case of default.
- Allow Port greater control over choice of issuing bank.
- Consider language which strips a tenant of all interest in proceeds drawn down from an LC, including reversionary or contingent interest.
 - ✦ Estate may seek turnover of LC proceeds if tenant retains any interest.

If a tenant does file for bankruptcy, the most important thing to remember is:



- Bankruptcy proceedings happen fast!
- Monitor court proceedings.
- Put in notice of appearance to receive all filings.
- Time frames can be very short to file objections (i.e. 1-5 days) to other claims or cure amounts.
- When in doubt, hire an expert.

