

Landlords Should Prep As WeWork Faces Potential Ch. 11

By **Gregory Petrick, Ingrid Bagby and Thomas Curtin** (August 25, 2023)

Three years have passed since the COVID-19 pandemic reached the United States and its effects are still being felt today.

Even though lockdown measures have largely disappeared, and many workers have returned to the office, flexible work has become a fixture in the workplace.

The shift to remote and more flexible work arrangements have affected many segments of the economy, perhaps most directly, commercial real estate companies.

The rise of remote work has reduced demand for office space, with some cities reporting office vacancy rates as high as 30%.^[1] And with less appetite for in-person work, companies have reduced the size of their office footprint.^[2]

WeWork Inc., a company that provides office space to individuals through a monthly subscription, as well as to companies through enterprise office space agreements, has been significantly affected by this trend.

In 2019, WeWork nearly collapsed as a result of its significant cash burn. The company avoided bankruptcy because it was bailed out by certain investors.^[5]

In New York City, WeWork was reportedly the largest leaseholder by 2019 and in 2022, WeWork reportedly leased 6.4 million square feet across more than 70 locations in Manhattan.^[4] At the end of 2022, WeWork had more than 18 million square feet of rentable office space in the U.S. and Canada.^[3]

Since the pandemic, WeWork's financial troubles have only grown worse. In April, WeWork defaulted on a loan for one of its office towers^[6] and closed one of its largest offices when it faced the prospect of an eviction lawsuit.^[7]

And, this month, WeWork announced in a financial filing that it had substantial doubt that it would be able to continue as a going concern, an indicator that absent recapitalization or restructuring, the company may need to seek bankruptcy protection in the future.

Issues in Potential WeWork Bankruptcy

Many of the office properties operated by WeWork and similar coworking entities are leased from landlords.

If WeWork seeks bankruptcy protection in the U.S., then it potentially can use tools in the U.S. Bankruptcy Code to rid itself of onerous leases. This could enhance either a reorganization of WeWork, or even a potential sale of the business.



Gregory Petrick



Ingrid Bagby



Thomas Curtin

Section 365 of the Bankruptcy Code empowers debtors to assume executory contracts and unexpired leases.[8] In order to assume a lease, a debtor must cure all defaults that may exist under the lease — other than a bankruptcy-related default.

Absent the grant of an extension by the court, the debtor generally has 120 days to assume an unexpired nonresidential lease of real property, according to Title 11 of the U.S. Code, Section 365(d)(4).

After that period has elapsed, any leases that have not been assumed are deemed rejected by the debtor.

Conversely, Section 365 also grants debtors the right to reject an unexpired lease or executory contract.

A rejection is treated as a breach of the lease under the Bankruptcy Code, which gives rise to an unsecured claim in favor of the nondebtor counterparty. The breach is treated as if it occurred on the petition date.

Post-petition rentals that accrue prior to rejection are treated as administrative expense claims, which means they have a higher priority of payment in the bankruptcy and must be paid in cash by the effective date of a Chapter 11 plan.

Debtors are therefore incentivized to quickly reject or assume leases in order to minimize expenses and the incurrence of administrative claims.

Section 502(b)(6) of the Bankruptcy Code sets forth limitations on the amount of damage claims arising from the rejection of unexpired leases.

Specifically, that section caps damages at "the rent reserved by such lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease."

Courts are split as to the method of calculating damages under Section 502(b)(6). Some courts interpret the 15% cap as applying to the percentage of rents due under the lease,[9] while other courts interpret the 15% cap as applying to the percentage of time remaining under the lease.[10]

Either way, commercial landlords of WeWork may face the prospect of having their damages capped in the event that their lease is rejected in bankruptcy. And, valuation of lease rejection damages could prove difficult to the extent that any leases are backed by secured debt.

WeWork is also party to various joint venture agreements. In a WeWork Chapter 11 case, these agreements potentially could be determined to be executory contracts and, if onerous to the WeWork debtor and its estate or go-forward business, the company could choose to reject those agreements.

Unlike leases, however, any rejection damages claim would not be capped under the Bankruptcy Code, but such claims for rejection would be general unsecured claims.

WeWork's corporate structure reportedly consists of a large amount of special purpose entities, which are the parties to various lease agreements.

These subsidiaries are generally in silos, which allegedly are parties to varying types of leases. For example, within the U.S., WeWork typically executes long-term leases for its office space.

Outside the U.S., WeWork does not execute long-term leases, and pursues alternative arrangements, such as management agreements and participating leases.[11]

Given these varying terms, incentives to assume or reject leases or similar agreements may vary across the silos, which could complicate the analysis for counterparties to such agreements.

Landlords and Contract Counterparties Should Prepare

The Bankruptcy Code gives debtors the power to reject unexpired leases to free themselves of unfavorable leases and executory contracts.

Given that WeWork leases many of its properties and now has admitted that it is experiencing financial distress, the company could potentially seek to reject unfavorable leases in the event that it files for bankruptcy protection.

And given that rejection damage claims for leases could be limited under Section 502(b)(6) of the Bankruptcy Code, creditors and landlords alike may wish to avoid bankruptcy altogether.

Thus, whether WeWork's recent going concern warning signals a bankruptcy filing remains to be seen, as the company's stakeholders may be incentivized to keep the company out of bankruptcy.

In the interim, counterparties to leases and significant contracts with WeWork should review those agreements now, and consider what strategies the contract counterparties can pursue to maximize their recoveries in a potential WeWork bankruptcy or restructuring.

Gregory Petrick is a partner and chair of the financial restructuring group at Cadwalader Wickersham & Taft LLP.

Ingrid Bagby is a partner at the firm.

Thomas Curtin is special counsel at the firm.

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[1] See How Cities Can Tackle Post-Pandemic Budgeting Dilemmas, Law360, May 16, 2023, available at <https://www.law360.com/articles/1606112/how-cities-can-tackle-post-pandemic-budgeting-dilemmas>.

[2] Yelp to Close Three of its Offices, Saying the "Future of Work" is Remote, CBS News (June 23, 2022), <https://www.cbsnews.com/news/yelp-closes-3-offices-future-of-work-is-remote/>; J.D Morris, Why Bad News for Downtown is Also Bad News for the Rest of

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[3] WeWork Has Sent a Distress Signal. Here's What to Know, N.Y. Times, Aug. 9, 2023, available at <https://www.nytimes.com/2023/08/09/business/wework-explain.html>.

[4] These Manhattan Landlords Stand to Lose Big as WeWork Bankruptcy Looms, Crains New York, Aug. 9, 2023.

[5] Softbank to Boost Stake in WeWork in Deal That Cuts Most Ties With Neumann, Wall Street Journal, Oct. 22, 2019, available at <https://www.wsj.com/articles/softbank-to-take-control-of-wework-11571746483>.

[6] WeWork, Rhone Venture Defaults on Loan for San Francisco Office Tower, Bloomberg, Apr. 13, 2023, available at <https://www.bloomberg.com/news/articles/2023-04-13/wework-venture-defaults-on-loan-for-san-francisco-office-tower#xj4y7vzkg>

[7] WeWork Hit With Eviction Lawsuit After It Closes Its Biggest Loop Location, Crain's Chicago Business, Apr. 17, 2023, available at <https://www.chicagobusiness.com/commercial-real-estate/wework-closes-loop-office-faces-eviction-lawsuit>.

[8] An executory contract is an agreement where both the debtor and non-debtor party have obligations that "are so far underperformed that the failure of either to complete performance would constitute material breach excusing the performance of the other." In re Interstate Bakeries Corp., 690 F.3d 1069, 1073 (8th Cir. 2012).

[9] See In re Rock & Republic Enters., 2011 Bankr. LEXIS 2401, *64 (Bankr. S.D.N.Y. June 20, 2011).

[10] See In re Cortlandt Liquidating LLC, 648 B.R. 137, 140-41 (Bankr. S.D.N.Y. 2023) (notwithstanding prior precedent in the Southern District of New York, court determined that "the Time Approach represents the correct view" of the cap on damages).

[11] See WeWork Form 10-K for 2021, available at <https://www.sec.gov/Archives/edgar/data/1813756/000181375623000016/we-20221231.htm>; see also Preparing for the Winter Storm? WeWork Pivots to Minimize Risk for Itself, WolfStreet, Jan. 18, 2019, available at <https://wolfstreet.com/2019/01/28/preparing-for-a-coming-winter-storm-wework-pivots-to-minimize-risk-for-itself/>.