WeWork bankruptcy: What should counterparties expect?

By John E. Murray

Some thoughts for lessors as WeWork teeters towards Chapter 11.

What’s the impact?

- WeWork is likely to use Chapter 11 to radically restructure its real estate footprint by rejecting some leases of co-working spaces and renegotiating others.
- Rejection damage claims are capped and treated as general unsecured claims, which typically face uncertain recovery prospects.
- Be prepared—lease restructuring settlements in bankruptcy contain traps that could lock in unfavorable long-term obligations for lessors.
- Payments made by the debtor outside the ordinary course of business within 90 days of a bankruptcy are potentially subject to clawback.

The We Company (WeWork) and many of its affiliates are widely expected to file for Chapter 11 bankruptcy in the next few days.

A WeWork Chapter 11 case is likely to involve a radical restructuring of the company’s lease footprint. As of June, WeWork operated 777 co-working spaces around the world, with over 500
subsidiaries serving as lessees. These leases amounted to approximately $25.1 billion in undiscounted long-term lease obligations on the company’s balance sheet.

**What can WeWork’s lessors expect?**

In Chapter 11, debtors can assume or reject unexpired leases and executory contracts under Section 365 of the Bankruptcy Code. This power is, as a matter of law, “all or nothing”—debtors can reject a lease and surrender the premises or assume the lease, cure all defaults, and continue operations. However, as a practical matter, in the already distressed commercial real estate market, WeWork may use the threat of rejection of its leases in bankruptcy as a means to extract painful concessions from lessors. Lessors should be careful when agreeing to restructure lease terms with a bankrupt WeWork. Bankruptcy settlements often contain many traps for the unwary, which could lock in less favorable long-term obligations for lessors.

**Bankruptcy guidance for WeWork counterparties**

There are several bankruptcy principles that counterparties should keep in mind as WeWork teeters toward Chapter 11:

/ A debtor may “reject” a burdensome or unprofitable executory contract or unexpired lease under Section 365 of the Bankruptcy Code. Bankruptcy courts will defer to a debtor’s business judgment on whether to assume or reject a lease or contract.

/ Rejection is akin to a prepetition breach of such lease or contract, and the debtor-tenant must surrender the premises.

/ The landlord of a rejected lease is entitled to a prepetition general unsecured claim, which is subject to a cap of the greater of

  • One year of rent or
  • 15%, not to exceed three years of the remaining term of such lease,
  • Plus, any unpaid rent.

**Navigating Rejection Damages Claims**

Rejection damages claims are treated as general unsecured claims and face uncertain recovery prospects. The Bankruptcy Code’s cap on damages at no more than three years of the remaining rent on a rejected lease will be cold comfort for landlords with long-term leases with a WeWork subsidiary.

Lessors are entitled to a priority claim for postpetition rent, even if the lease is ultimately rejected. Although the venue for a WeWork bankruptcy case is unknown, within the Third Circuit (a venue of choice for many “mega” Chapter 11 cases), lessors are specifically entitled to a priority claim for “stub rent”—rent accrued between the petition date and the next due date.
Rejection only excuses the debtor from its obligations under the lease; rejection does not affect the obligations of non-debtors.

**Looking ahead**

Customers of WeWork are referred to as “members,” and there are various classes of membership that may each be treated differently in bankruptcy; for example, some could be classified as “licenses” or “subleases.” It is unclear how WeWork’s various classes of memberships will be treated in bankruptcy; subleases are treated differently than, for example, ordinary memberships. Subtenants of a rejected sublease are entitled to certain protections under Section 365 of the Bankruptcy Code, provided they continue to abide by the terms of a sublease and pay rent (minus any damages). However, license holders are not entitled to such protections.

In connection with any negotiations with a bankrupt-WeWork, lessors will also need to evaluate their preference exposure. A bankrupt WeWork may seek to clawback certain payments made within 90 days of its bankruptcy, outside of the ordinary course of business, such as settlements, and may use the threat of preference/clawback litigation as leverage in lease negotiations.

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