The Effect of the Current Economic Crisis on Leasing

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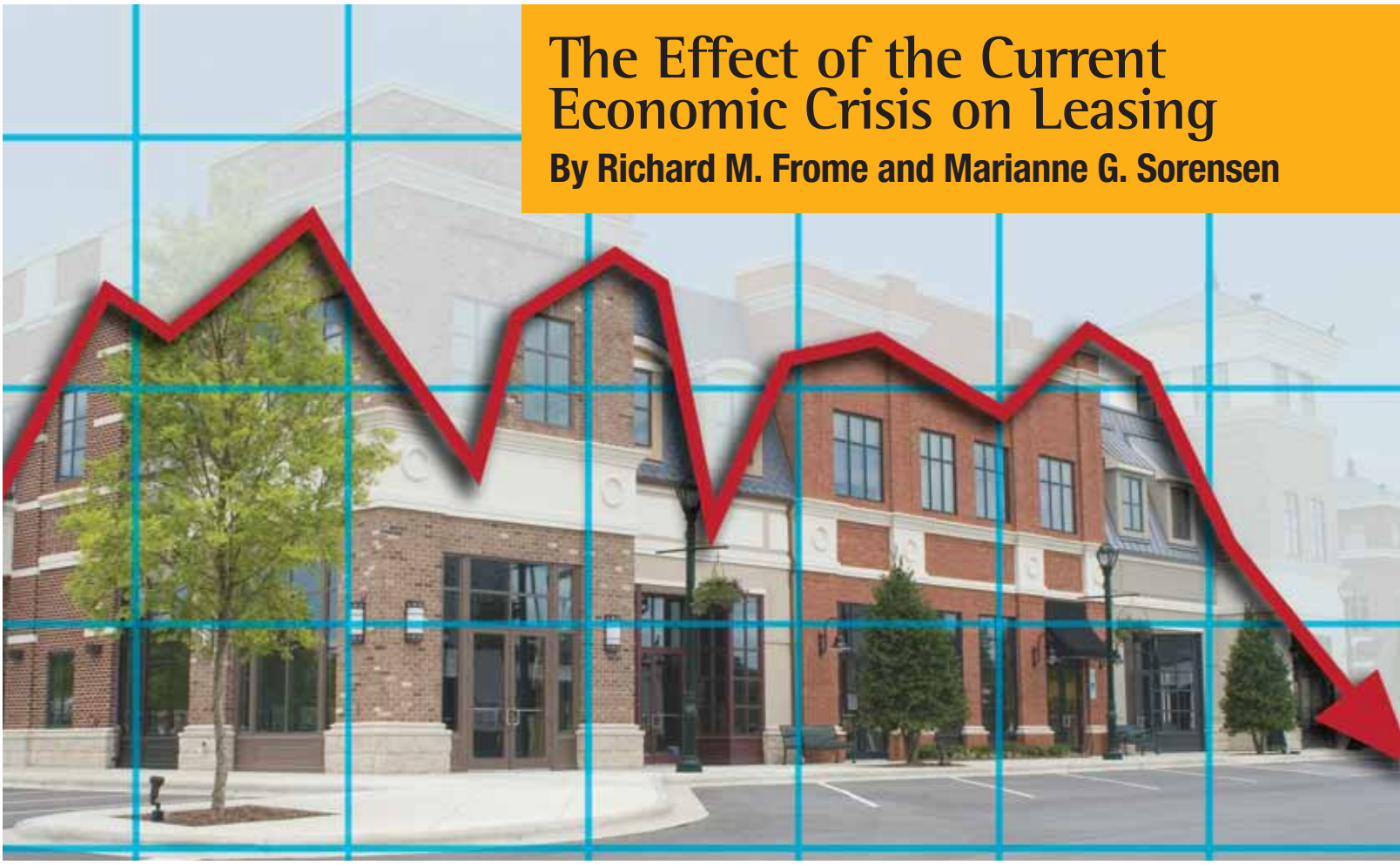

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Over the past several years the general economic crisis has affected commercial real estate leasing in a profound way. This article summarizes the collective thoughts of the authors, enhanced by discussions among other members of the RPTE Section's Leasing Group, about changes in commercial leasing practice and documentation as a result of the financial meltdown.

Creditworthiness and Security

Because the weakened economy has affected even the strongest tenants, landlords must be more concerned about the amount and type of security deposits and the need for guarantees (and, of course, the creditworthiness of the tenant itself) than in previous years. As a general rule, letters of credit are considered better than cash as security because of the independence principle. "The letter of credit . . . is designed to be completely independent of the underlying commercial transaction between the customer/buyer and the beneficiary/seller. Thus, a letter of credit that pledges the bank's credit, regardless of what transpires in the underlying transaction, satisfies the seller's need for assurance of payment." *Mercantile-Safe Deposit & Trust Co. v. Baltimore City*, 526 A.2d 591 (Md. 1987). So, for example, although a landlord's failure to make repairs might be a defense to the landlord's action for nonpayment of rent, it is not a defense to a landlord's demand on a bank for payment on a letter of credit. If the payment demand is tendered in strict compliance with the drawing conditions of the letter of credit, the issuer must make payment to the landlord. The tenant's recourse is to sue the landlord after the draw for an unjustified draw of funds not due. Only in extremely rare cases, usually limited to fraud and forgery, can the tenant obtain an injunction in advance preventing the bank from paying.

Another major benefit to the landlord provided by a letter of credit has traditionally been that, in virtually all cases, if the tenant becomes a debtor in a bankruptcy proceeding, the landlord may draw on the letter of credit to collect the damages due by reason of the tenant's default without being restrained by the automatic stay of the Bankruptcy Code. 11 U.S.C. § 362. Because cash is treated as part of the bankrupt estate and the landlord is treated as a secured creditor, the automatic stay prevents the landlord from applying a cash security deposit

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to landlord's damages post-petition without permission of the bankruptcy court. Application of cash deposits before the bankruptcy petition may have a different result, depending on lease provisions. If a landlord has notice of a default, applies the cash deposit to past due amounts in accordance with the lease, and gives the tenant notice of this application, all before the bankruptcy petition is filed, then the landlord's application of the deposit should not be affected by the bankruptcy filing. If the landlord did not have the right under the terms of the lease to offset the deposit against the past-due amount pre-petition or did not formalize this offset, then generally the landlord should wait until the entire bankruptcy case is wrapped up to apply the cash security deposit. In the few reported cases dealing with this scenario, however, courts have been lenient toward landlords that acted post-petition and without court authority to offset the cash deposit against the unpaid rent. *In re Valentine*, 125 B.R. 11, 13 (S.D. Ohio 1991) (Chapter 13 case in which the court observed, "[a]lthough the setoff of the $200 deposit by [the landlord] may have been a technical violation of the automatic stay of § 362, the application of the setoff is permissive and lies within the equitable discretion of the court"). See also *In re Morningstar Enterprises, Inc.*, 128 B.R. 102, 105 (E.D. Pa. 1991) (Chapter 11 case in which the court found that the landlord violated the automatic stay by unilaterally setting off part of the security deposit against pre-petition rent arrearages, but found that this action was mitigated by the fact that the landlord had a "'special interest' similar to, if not the equivalent of, a security interest in the escrow deposit funds"). Conversely, a letter of credit posted as security is not part of the estate. It may, however, be subject to the so-called "cap" limiting lease claims to post-bankruptcy rent of the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease. 11 U.S.C. § 502(b)(6). The reliability of letters of credit has also diminished somewhat in the recent past as banks suffer their own economic woes. Contrary to traditional wisdom, some commentators have now concluded that a landlord is frequently better off with a cash security deposit because a receivership of the issuing bank will allow the FDIC to wipe out the letter of credit obligations of the bank.

Landlords should consider seeking more security at the start of the term, with the amount "burning-down," or reducing, as time passes without a tenant lease default. This concept ensures payment early in the term, when the landlord is most at risk because it has incurred the costs of free rent, brokers, lawyers, and perhaps construction. Once those amounts have been recovered by rent collection, the security deposit can be reduced because even if rent is subsequently interrupted by tenant default, at least the landlord is not out of pocket in excess of rents collected.

Landlords should ensure that the lease security deposit clause takes into account two concepts. First, the lease should protect the right of the landlord to collect on the security swiftly when default is imminent. Second, the lease should permit application of the security deposit to as many items as possible so that the initial withdrawal is as large as possible.

Landlords should review tenant financial statements more closely. A corporate tenant with large shareholder equity, but whose major asset is goodwill (which is after all just a bookkeeping entry reflecting the excess of amounts paid for an acquisition over the hard value of the assets bought), inventory, or real estate (the value of which is often not so clear), might be less creditworthy than a tenant with liquid assets such as cash.

Many landlords are now much less inclined to spend cash to obtain a tenant. Landlords that formerly constructed or paid a cash tenant allowance for tenant alterations to new leased space now may agree to offer only free rent in an equivalent amount. Of course, if the tenant cannot itself advance the cash or borrow money for its build-out, the lease cannot be made.

Some landlords are requiring small tenants to make their initial payments by certified checks. Small local tenants often dream that they somehow will be able to deposit funds sufficient to cover the checks they deliver by the time the landlord reviews the lease, signs it, and returns it. As with all troublesome issues, it is better to find out sooner rather than later that the checks for advance rent and security deposits will not be honored by the bank.

Just as landlords need to be vigilant regarding tenants' financial strength, the same is true for tenants. It has been a while since such an issue has arisen, but today even some of the largest landlords may have solvency issues. Can a tenant protect itself?

The tenant needs evidence of the landlord's ability to pay initial tenant work allowances or to perform the landlord's work. The tenant may want to seek its own security, such as a letter of credit from the landlord, a guarantee from the landlord's parent company, or a cash deposit from an individual owner.

Tenants also must be more concerned about the provisions of nondisturbance and attornment agreements, aside from the customary exculpations of lenders. Lenders expect to be exculpated, but in these times it may be prudent and reasonable for tenants to insist on recognition from lenders of the tenant's rights under the lease to free rent, allowances, and cash. This is especially true in the case of free rent, considering that the lender will enjoy the benefit of the remaining rent if it forecloses. Perhaps a tenant can even obtain the agreement of the lender to complete the landlord's work or allow the tenant to do the work in return for a rent credit, assuming the tenant can bear the initial cost, though few lenders will want to spend money on property acquired by foreclosure or deed in lieu of foreclosure or to permit a tenant of that property to abate rent to pay for improvements to that property. A landlord can sometimes induce a lender to agree to this provision if it provides the lender with a cash escrow in the amount of the construction allowance.

Timing and Tenant Construction

Another area of concern for both a tenant and a landlord is the presence of an existing occupant of the space. What happens to the landlord's and new tenant's best laid plans if the existing tenant files for bankruptcy protection and does not vacate

or, even outside of bankruptcy, simply cannot afford to move or find new space? The landlord and the new tenant should try to find out the plans of the old tenant, including where the old tenant is moving: is it a new building or a large build-out (which are always delay-prone)? The process is quite similar to that in a single family house purchase—if the new house to which your seller plans to move is not ready, what will happen?

If the landlord has other vacancies, perhaps the new tenant can seek swing space—space it can move into temporarily until the leased premises are ready. This remedy is less than ideal but helps the new tenant avoid a holdover damages claim from its existing landlord. It also helps the new landlord avoid having to agree to pay specified damages to the new tenant if the promised space is not delivered on time. Another potential remedy, a right of lease cancellation, is threatening to the landlord but really provides only cold comfort for the tenant. If the tenant exercises this cancellation right, it must swiftly and unexpectedly find a new location, draw plans, negotiate the new lease, complete its build-out, and move to the alternative space, all before it is evicted from its existing space.

A landlord also is confronted with issues of timing. A landlord might try to impose strict limits on the length of time provided for the tenant to perform its initial build-out work. This is a balancing act because, if the landlord can still cancel the lease after a substantial part of the work has been completed, the tenant is left empty-handed. This area requires very close study by the tenant, and the tenant should fight hard for force majeure-type protection.

The landlord should be concerned about the tenant tying up vacant space while the tenant is seeking funds to continue its job. On the one hand, the landlord does not want the tenant to sink into insolvency or commence a bankruptcy case, tying up the space with nothing moving forward. On the other hand, is a time cutoff date termination provision enforceable? Once the force majeure issue comes into play there is almost no predicting how good a case the tenant can make that the delay was beyond its control. Delay seems clearly a question of fact that will be litigated for a while, because the question of what is beyond one's control is one of the grayest of gray areas. For this reason, there is some minor disagreement among observers about whether a force majeure provision for the tenant should ever be acceptable to a landlord. Tenant default provisions that allow a tenant a reasonable time to remedy a default using due diligence are troublesome enough. These troubles are increased geometrically when a "beyond reasonable control" standard must also be overcome. Tenants argue, however, that if it is not commercially possible for a tenant to accomplish an act, how can that tenant be held culpable?

Construction Shortcuts

Another issue about which each party must be concerned is shortcuts by the other in its construction obligations. In trying times, parties sometimes attempt to minimize build-out expenditures. Many lease schedules contain vague standards describing work and specifications, and these standards may need to be tightened. Is "building standard" really a clear enough standard for the quality of improvements—other than for a new building where there really is a contemporaneous standard? In a mature structure, specifications, quality, brand names, and models change over time, so what is the standard? In addition, more extensive supervision may be needed by each party of the other's work to be sure the work meets the lease's quality obligations. Finally, the landlord should now take more care about mechanic's liens, especially in imposing conditions on the landlord's payments toward the tenant work.

Good protection for tenants, especially with smaller landlords, is the tenant's right to cure the landlord's failure to fulfill a construction obligation. This type of clause provides that if the landlord fails to perform the construction and if the tenant has the funds available, then the tenant can perform the work and avoid the delay of a landlord that cannot pay. A tenant also should try to include a provision giving it the right to deduct these cure costs from rent. Although it is not clear that this works in all cases, and this remedy is undoubtedly better in a local strip mall than a large center, at least it will permit the tenant to do its own demolition, cleanup, floor leveling, and similar work. If there is a mortgage and the tenant obtains a nondisturbance agreement from landlord's lender, the tenant should try to preserve this right in case of foreclosure.

Rent and Use

Landlords are now reviewing their rent collection procedures. If a tenant is in trouble, it is best for the landlord to find out as soon as possible. It might be prudent to make lease payment provisions tighter—for example, a shorter grace period for default and for the accrual of late charges.

Grace periods, which provide the tenant with notice and a cure period for rent payment defaults, can be a function of local court procedures. In jurisdictions where the termination of a lease and recovery of possession is a protracted process, a few days more or less for cure are of no significance. Some landlords use provisions giving them the right to declare a default and cancel the lease immediately, without notice and a cure period, if the tenant fails to pay rent after the landlord has given the tenant a certain number of prior default notices, but tenants counter that part of the price of being a landlord is mailing a notice and that a tenant should always have the courtesy of notice and a right to cure before it can be required to forfeit its investment in construction and preparation of the space. Tenants are also concerned with the possibly fatal consequence to their businesses of being thrown out of their leased space. A tenant should fight hard to try to ensure that it gets some kind of cure notice before it can be thrown out.

Landlords should include late charges both to reimburse the landlord for the value of money not received and, at least equally important, to encourage tenants that need encouragement to pay promptly. For the same reasons, landlords may also wish to include a provision for interest that accrues on past due rent payments at a stipulated rate that is higher than the rate charged by the tenant's trade creditors.

Use provisions are also sensitive in a softer leasing climate. A landlord should try to keep its use provisions narrow to avoid uses by the original tenant or its subtenants or assigns that would be detrimental to the premises or the building in which the premises are located. Tight use clauses are also important in a retail property to assure a profitable tenant mix and to avoid duplication of tenant retail offerings.

Even more important, particularly in retail leases, is crafting use clauses that do not violate exclusive use provisions in other leases in the same building or shopping center in favor of other tenants. If a landlord gives Tenant A the exclusive right to use the leased premises for a particular use, the landlord gives up the right to lease other space in the same development for that same use—even if Tenant A is not then engaging in that use as a major part of its business. Conversely, a tenant must be sensitive to overly snug clauses that prevent it from expanding its use in a slow business environment or that overly restrict its ability to assign. If the original tenant is a good operator, it is unlikely that it will find an assignee that will agree to be bound to exactly the same use as the assignor's failing business.

Assignment and Subletting

Should the landlord review the tenant's credit, in addition to that of the prospective subtenant, before consenting to a sublease? Should the landlord also review the subtenant's credit with a view to the risk of bankruptcy, which might permit relatively uncontrolled assignments in the bankruptcy proceeding? The financial crisis has enhanced the possibility of bankruptcy so much that landlords now regret having agreed in their older leases to give the tenant the right to sublease without full financial testing. Should the landlord request a guaranty of the lease by the subtenant? These considerations also might apply to subleasing to affiliates and subsidiaries.

Does a reasonable consent provision allow a landlord to require additional security without a specific right under the lease to do so? Is there an added risk against which it is reasonable for a landlord to try to protect? But what is the difference if there is an added layer of subtenant interest? In fact, is the landlord's situation improved by adding layers of sub-interests? Some landlords try to limit the number of layers (sublease, subsublease, and so on) for administrative convenience, but one must wonder if they are wise these days to pass up the added parties who might pay the rent if others do not. Landlords should seek an attornment agreement under which each holder of a sub-interest agrees to pay rent to the landlord if its sublessor defaults or even an agreement by the subtenant to be bound under the lease to the same extent that the tenant is bound.

Miscellaneous Considerations

Many shopping center tenants are now concentrating more on the issue of cotenancy: the requirement that certain other specified tenants be open for business. In a cotenancy provision, the landlord agrees that if the required tenants in the shopping center are not open and operating, the tenant has the right to close, cancel the lease, or have its rent reduced or converted to percentage rent in lieu of any fixed rent. For example, in 2008, a tenant in a center whose main tenant was a Circuit City may have required a provision stating that it will have the right to go dark, terminate, or reduce its rent if Circuit City ceases to be open and operating. Circuit City closed all its stores after it was liquidated in bankruptcy in 2009, and now the traffic in the center is adversely affected, the tenant needs relief, and the remedies under the cotenancy provision should provide the tenant with this relief. When a tenant in a shopping center enters into a lease today, it must consider the consequences if important tenants of the center close for business, and it should provide relief in the lease for this closing. Landlords, on the other hand, should be very careful to give themselves sufficient time to replace tenants that close, even if it means giving the other tenants the right to pay only percentage rent during this period, and they should be sure that casualties will not trigger a cotenancy termination.

The landlord should also be more careful about monitoring the tenant's insurance compliance. If the tenant is running out of money, one of the easiest things to cut back on is insurance premiums. The landlord must heighten its review of proof of insurance, and its supervision of renewals and cancellations, as well as reductions in coverage and the quality of carriers. Another risk area is the legal consequence of permit and license lapses.

In new leases, a landlord should consider obtaining the right to review the financials of the tenant as a condition to the exercise of options of renewal or expansion and reserving the right to reject them or to require additional security based on specified criteria. In addition, the landlord may try to obtain periodic financial information about the tenant as well as sales information of the store leased (of course, if there is percentage rent, this is already available). The landlord's need to review the tenant's financial statements should apply equally to office and to retail properties because such information could signal a warning of impending troubles threatening the tenant.

Finally, how does a tenant protect itself from a landlord's bankruptcy? Under Bankruptcy Code § 365, the tenant's lease can be rejected by the landlord in a landlord's bankruptcy. 11 U.S.C. § 365. It is true the tenant cannot be evicted, but it cannot demand services from the landlord. Typically, the lender takes over to keep the property operating and renders the basic services, but the tenant cannot expect anything too elaborate, and, along with the offset rights provided in 11 U.S.C. § 365(h)(1)(B), any right it has reserved in its lease to cure the landlord's defaults and deduct the cost from rent will stand it in good stead. The tenant also can accept the rejection and vacate.

Conclusion

One hopes that the difficult times will end soon and that leasing and retail and business finances in general will return to their pre-crisis conditions. In the meantime, lawyers should consider how to protect their leasing clients and perhaps make some lease form tweaks to try to improve their clients' position under the current uncertain conditions. ■