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LEASE GUARANTIES AND OTHER TECHNIQUES TO SECURE PERFORMANCE OF LEASE OBLIGATIONS

I. Introduction

The past few years have been difficult for the real estate industry. There has been an increase in tenant bankruptcies and tenant defaults. There have also been more landlord defaults, landlord bankruptcies and lender foreclosures which have resulted in unfinished projects and uncompleted tenant stores. Landlords are looking to secure tenant obligations to pay rent and to perform other lease obligations, including tenant buildout obligations. Options available to landlords include cash security deposits, letters of credit, third party lease guaranties and construction bonds. Tenants too are concerned about the landlord's ability to perform its lease obligations, particularly landlord obligations to build out the tenant's premises and/or to pay tenant an improvement allowance. Tenants are now asking landlords to provide letters of credit or third party payment guaranties to secure these obligations, or tenants are requiring landlords to use escrow accounts for construction funds and tenant improvement allowances. Tenants are negotiating for self help rights to perform landlord construction obligations with respect to the tenant's store and for the right to offset construction costs and the amount of any unpaid landlord improvement allowance from the rent due under the lease.

A. Guaranties

Guaranties provide a means for both landlords and tenants to obtain additional security for the performance of the lease obligations of the other party. The creditworthiness of the guarantor should be carefully evaluated. Although state laws vary on the requirements for a guaranty, a guaranty is typically subject to the statute of frauds and must be in writing and must be supported by consideration. If there is inadequate consideration, the guarantor has a defense to the enforcement of the guaranty. The execution of a lease at the same time as the guaranty is generally sufficient consideration for the guaranty. There are different types of guaranties and the parties to the guaranty should make clear the type of guaranty and the specific obligations covered. The guaranty should state that it is unconditional and irrevocable. State laws vary, but in some states a continuing guaranty is revocable by the guarantor at any time with respect to future transactions unless the guarantor waives the right to revoke its guaranty. The guaranty may be a payment guaranty or a performance guaranty. A guaranty may distinguish between a guaranty of payment and a guaranty of collection. With a guaranty of payment, upon the tenant's default in the payment of rent, the landlord is not required to pursue the tenant first before proceeding against the guarantor. If the guaranty is of collection only, the guarantor only guarantees that the rent due under the lease will be collectible from the tenant. The landlord must attempt to collect the rent from the tenant and to exhaust

its remedies against the tenant before it can pursue the guarantor. The guaranty should specify the obligation that is being guaranteed. From the landlord's standpoint, the guaranty should be broadly drafted to secure all the tenant's lease obligations and payments due under the lease. If the guaranty is only for specific obligations, those obligations should be clearly defined.

Obligations under a guaranty may be capped or limited in other ways. The guarantor may seek to limit its liability to a certain dollar amount. The guaranty may provide for a "bum off' where the guarantor's liability is reduced over time if the tenant has not defaulted, or the guaranty may provide that the guaranty will terminate after a fixed period, e.g., five years, if the tenant has not previously defaulted under the lease. A guarantor may also seek a termination of the guaranty if the tenant achieves a stated net worth or if the tenant's sales from its premises reach a certain threshold. If the amount of the guaranty is capped, the guaranty should state that the guarantor's liability is not affected by the landlord's collection of any amounts from the tenant or application of the tenant's security deposit, unless the landlord receives full payment of the amounts owed by the tenant. The guaranty should also state that attorneys' fees and cost of collection on the lease or the guaranty are not included within the cap, and that the guarantor remains liable for such attorneys' fees and costs. If a guaranty terminates at the end of the fifth lease year of the term, (the "guaranty period"), the guaranty should state that guarantor's obligations under the guaranty shall terminate at the end of the guaranty period, only as to obligations accruing or arising after the end of the guaranty period. The guaranty should only terminate if tenant is not then in default under the lease and if tenant has not been in default at any time during the guaranty period. The guaranty should make clear that the termination does not apply to any tenant default occurring during the guaranty period or to any event occurring during the guaranty period which, with the giving of notice or the passage of time, would constitute a tenant default under the lease.

Guaranties may also limit liability by including "good guy" guarantor provisions. Under a typical good guy guaranty, the guarantor will only be liable for rent for the period of time that the tenant remains in possession of the leased premises. If the tenant defaults, but the tenant promptly surrenders the premises and does not file bankruptcy or otherwise interfere with the landlord's ability to retake the premises, the guarantor is not obligated for future rent after the date the tenant vacates the premises, although the landlord retains its right to pursue the tenant for future rent and other damages due to the tenant's default. A guarantor may seek to limit its guaranty in other ways, such as by requiring that its guaranty not apply to any extension or renewal of the lease or if the lease is assigned or the leased premises are sublet. The guarantor may also try to limit its guaranty to the original landlord only. If the landlord transfers its interest in the lease,

the guaranty terminates (at least as to tenant obligations arising after the date the lease is transferred by landlord).

State laws give guarantors and other sureties various defenses to the enforcement of the guaranteed obligations. Therefore, it is important to include in the guaranty the guarantor's waiver of various defenses. It is typical for a guaranty to include the guarantor's waiver of (a) any right to require the landlord to pursue any remedy against the tenant or any other person before proceeding against the guarantor; (b) any right or defense based on the release or discharge of the tenant from its obligations under the lease in any bankruptcy or other similar proceeding or any rejection of the lease in a bankruptcy proceeding; (c) any right or defense arising due to the incapacity, death or disability or lack of authority of the tenant or any other person; (d) any right or defense due to tenant's assignment or transfer of the lease or sublease of all or any part of the premises (see below); (e) the benefit of any statute of limitations affecting the liability of the guarantor under the guaranty or the enforcement of the guaranty; (f) any defenses based on the lack of any demands, presentments or notices; (g) any obligation on the part of the landlord to disclose facts about the tenant that materially increase the risk to the guarantor; and (h) any defenses due to amendments to the lease made after the date of the guaranty without guarantor's consent (see below). Lease amendments should be specifically addressed in the guaranty as amendments after the execution of the guaranty, without the guarantor's consent, may make the guaranty unenforceable. Accordingly, the guaranty should expressly state that the guarantor's obligations will not be altered or released by any modification of the lease, including any change in the size of the premises, and that the guaranty will apply to any extension or renewal of the lease and any holdover term following the end of the term of the lease. In practice, if the landlord is contemplating entering into a material modification of the lease that arguably would increase the risk to or the obligations of the guarantor under the lease, such as consenting to an expansion of the premises or an increase in rent in consideration of some other concession granted by the landlord to the tenant, the landlord may seek the consent of the guarantor to such a material modification of the lease. From the landlord's perspective, the guaranty should expressly provide that the guaranty continues, notwithstanding an assignment of the lease or a sublease of the premises.

A guaranty should require the guarantor to waive any subrogation rights it has against the tenant until all of tenant's obligations under the lease are fully performed. The guaranty should also provide that the guarantor subordinates any liability or indebtedness of the tenant in favor of the guarantor to tenant's obligations to landlord under the lease.

Another issue for the landlord to consider is if the tenant pays

its rent obligations in full but the tenant later files bankruptcy and certain tenant payments to the landlord are voided on bankruptcy grounds. If the landlord must return the voided payments to the tenant, the guarantor may argue that the tenant's payment of the rent obligations terminated the guaranty and that the guarantor's obligations were not automatically revived just because the landlord had to return those payments. To minimize this risk, the guaranty should expressly state that the guaranty will revive if the landlord is required to return money to the tenant.

B. Security Deposits.

The simplest way for a landlord to secure a tenant' s obligations under a lease is to collect a cash security deposit. Nonetheless, landlords may have greater issues realizing and retaining cash security deposits, particularly in the event of a tenant bankruptcy, than landlords expect.

The first question with respect to cash security deposits is the proper size of the security deposit. Landlords should analyze the assets of the tenant against the obligations under the lease, the landlord's costs and the likely time to re-let the premises. Second, many tenants will ask that the security deposit burn off in whole or in part as (a) the tenant proves itself to be a tenant in good standing with a successful business and (b) as the remaining obligations outstanding under the lease diminish as the lease term gets closer to its expiration. In considering whether to grant such a return of part or all of the security deposit, the landlord should consider the terms under which the landlord would be willing to return part or all of the deposit. The deposit should be offset from rent so that the landlord does not run any risk of returning the deposit without rent being paid. The landlord should only agree to return the deposit provided that the tenant has been in good standing throughout the term.

In drafting security deposit provisions in a lease, the practitioner should be aware of the particular state law issues governing security deposits in the jurisdiction where the shopping center is located. Many states have limitations on the uses to which a security deposit may be put. Some states allow security deposits to secure all of the tenant's obligations under the lease, but others only allow security deposits to secure "rent" obligations. In the latter states, the landlord should be sure that all obligations, including net rent, common area expenses, taxes, indemnities, repairs, attorney's fees and the like are all defined as rent obligations under the lease. In addition, some states require that security deposits be held in separate, interest bearing accounts and that the interest belongs to the tenant, although these laws are more likely to apply to residential than commercial leases.

The landlord should make sure that its lease form is clear about the circumstances and timing of when a landlord may apply a security deposit against tenant obligations under the lease, and if the landlord intends to so apply the security deposit, the landlord must carefully follow the terms of the lease in doing so. Some states also have requirements about how and when the landlord must return the security deposit. Some states, such as Texas, require that the landlord return the security deposit within a certain amount of time following the end of the lease term or incur penalties.

In addition, the landlord should be aware of its rights if the tenant files bankruptcy with respect to its ability to retain a security deposit to make the landlord whole for its losses. If a tenant files bankruptcy and rejects the lease, the landlord's claim for damages is limited to the greater of one year's rent or 15% of the unaccelerated rent, not to exceed three years' rent (Bankruptcy Code Section 502(b)(6)). The cash security deposit, even though it is held by the landlord, is an asset of the tenant's bankruptcy estate. Thus, the fact that a landlord may have obtained a cash security deposit in excess of this cap does not mean that the landlord has a right to greater damages than bankruptcy allows.

C. Letter of Credit as Security

A letter of credit is a commitment from a bank or other financial institution (the "issuer") to pay a beneficiary, e.g. the landlord, for the account of the applicant (e.g. the tenant) to pay the amount of the letter of credit to the beneficiary upon the beneficiary's draw on the letter of credit. There are two basic types of letter of credit, the standby letter of credit and the commercial letter of credit. A commercial letter of credit is generally used in sales transactions and is intended to be drawn upon, e.g., the letter of credit will be drawn against when the seller delivers goods to the buyer and the seller delivers to the issuing bank evidence of the seller's delivery of the goods. A standby letter of credit is intended to be security for the applicant's obligation to the beneficiary which will only be paid if the applicant defaults.

Letters of credit are subject to Article 5 of the Uniform Commercial Code. However, the parties to a letter of credit can adopt other rules or codes to apply to the rights of the parties (except for certain rights that under the Uniform Commercial Code cannot be modified) to the extent that the issuing bank is willing.

The lease will include specific provisions governing the letter of credit. These lease provisions typically include the following: (a) the letter of credit shall be delivered by tenant to landlord as collateral for the performance of all tenant's obligations under the lease; (b) the letter of credit shall be a standby unconditional, irrevocable and

transferrable letter of credit; (c) the amount of the letter of credit; (d) the issuer of the letter of credit shall be a financial institution acceptable to the landlord in its sole discretion; (e) the landlord may wish to specify that the offices where the letter of credit can be drawn must be located in a specific city (convenient to the landlord); (f) the letter of credit shall not be mortgaged, assigned or encumbered by the tenant; (g) the tenant shall cause the letter of credit to be continuously maintained in effect through a specified date ("Outside LOC Expiration Date"), e.g., the date which is ninety (90) days after the expiration of the term of the lease; and (h) a letter of credit is typically issued for a one year term.

The lease provisions should also specify when the landlord has the right to draw on the letter of credit. From the landlord' s standpoint, the landlord should have the right to draw on the letter of credit, in whole or in part, at any time and from time to time upon the occurrence of specified events, e.g., if the tenant fails to perform any monetary obligation under the lease when due; or if the tenant fails to deliver a new letter of credit to landlord at least thirty (30) days before the expiration date of the letter of credit or after landlord's receipt of a notice from the issuer that the letter of credit will not be renewed; or if tenant become insolvent or files bankruptcy; or if tenant fails to perform any other covenants under the lease.

The lease should provide that proceeds from the letter of credit may be applied by the landlord against the payment of any rent or other sums due by tenant under the lease that are not paid when due and to also pay all damages landlord incurs or will incur as a result of any default by tenant under the lease. The lease should also provide for restoration of the letter of credit if the landlord partially draws on the letter of credit.

The lease should provide that landlord may, without notice to the tenant or without tenant's consent, transfer all or any part of its interest in the letter of credit to any other person, including landlord's lender and any purchaser of the property in which the leased premises are located. The foam and wording of the letter of credit itself should be carefully negotiated by the landlord, as beneficiary. The landlord wants the conditions on the draw to be simple and to not require specific documents or exact wording.

II. Construction Bonds, Escrow Accounts and Other Techniques to Secure Performance of Construction Obligations

One of the risky times during the life of a lease for both the landlord and the tenant is the initial construction period, especially in retail leases when premises are typically completely remodeled for each new tenant.

Both landlords and tenants are more leery of the other party's ability to meet these obligations and are looking to secure these construction obligations through escrow accounts, construction bonds, guaranties and letters of credit.

A. Escrow Accounts

Either a landlord or a tenant may require that funds needed for build out costs or construction allowances be escrowed through the construction period. If the parties determine to use an escrow account, the party making the deposit should use an escrow company who will act as the escrow agent on terms acceptable to the parties. Escrow agreements can be negotiated to suit the parties' needs. The main disadvantages of escrow accounts are twofold. First, the escrow company will earn a fee for providing the service, so it adds a cost to the deal. Second, if there is a dispute between the parties as to whether the funds should be paid out, typically the escrow company will simply hold the funds until the parties work out their dispute through settlement or the courts.

B. Construction Bonds

Leases often require tenants to obtain construction bonds for tenant's work, although how often that requirement is enforced is another question. Construction bonds come in two forms, completion bonds and payment and performance bonds. Each bond serves a separate purpose, completion bonds secure against a party's financial inability to complete the project, and payment and performance bonds (actually two separate bonds) are primarily used to protect against mechanics liens and contractor defaults. A major issue with completion bonds in particular from both parties perspective is that the bonding company will require security for its bond, which both parties could use without needing to use a bonding company through security deposits or escrow accounts, both of which may be more economical to use. In addition, both completion bonds and payment and performance bonds can be quite expensive, making them less attractive ways to secure performance of a tenant build out than some of the other methods we have outlined in this workshop. Bonds are more often used in development projects with more substantial costs.

C. Self-Help Rights

In development projects or high capital cost projects such as theaters or restaurants, tenants today are concerned with the higher incident of landlord defaults, landlord bankruptcies and lender foreclosures resulting in unfinished projects and individual stores. In addition to the various types of security discussed above, tenants may wish to negotiate self help rights to complete the build out of the store that the landlord started but did not finish. These self-help rights can

allow tenants both to finish their build-outs and in certain circumstances, the common area improvements necessary for the tenant to operate its business. The tenant will want the right to offset the cost of its exercise of its self-help right against rent to be paid under the lease.