Landlords Beware: Bank Leases and Letters of Credit Are in Jeopardy

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The final totals are in: the Federal Deposit Insurance Corporation (FDIC) closed 157 banks in 2010. With more than 860 banks on the FDIC's growing troubled bank list, bank closures are likely to continue at a similar pace in 2011. This is troubling news for landlords. Not only are increasing numbers of lenders likely to close their doors in the current economic climate, the consequences of a failure are potentially more severe than with other types of tenants. Now more than ever, landlords must be aware of the unique risks presented by this tenant class.

If you're a commercial landlord, you probably recognize the risk that any of your tenants can go bankrupt at any time. That's why you make credit checks and investigate the financial strength of potential tenants up front. You may also know that, if a tenant does in fact go under, you will have a claim in bankruptcy for some amount of lost future rents. But suppose your tenant is an FDIC-insured depository institution (bank, savings and loan, or the like). Did you know that, if such an institution fails, its lease could be terminated and you would be left without even the level of damages available in a bankruptcy?

The Federal Deposit Insurance Act (FDIA) was significantly amended in 1989 by the Financial Institutions Reform, Recovery and Enforcement Act, in response to the savings and loan crisis of the 1980s. Under the amended FDIA, the FDIC has the authority to take over failed FDIC-insured depository institutions. If it does take control of an institution, the FDIC has the power to "disaffirm or repudiate any contract or lease...to which such institution is a party," provided that it determines that the performance of such contract or lease would be "burdensome" and the disaffirmance would "promote the orderly administration of the institution's affairs." 12 U.S.C. §1821(e)(1). This is akin to the right of a trustee in bankruptcy to reject an executory contract or lease.

Under bankruptcy law, the landlord under a rejected lease generally is entitled to claim damages for future rent, in an amount not exceeding rent for the greater of (a) one year under the lease, or (b) 15 percent (not to exceed three years) of the remaining term of the lease. The claim is unsecured, putting the landlord on the same footing as all other unsecured creditors of the bankrupt's estate. While a landlord's claim in bankruptcy is not equivalent to the damages available to a landlord under state law in the absence of bankruptcy, the bankruptcy code affords the landlord some relief, and gives the landlord some breathing space to find a new tenant.

However, under the FDIA, if a lease is repudiated by the FDIC, the landlord is left with **no** claim for future damages. The landlord can make a claim for rent accruing **before** the effective date of the disaffirmance (or the date the notice of disaffirmance is mailed, if later), but the FDIA expressly states that a landlord will have "no claim for damages under any acceleration clause or other penalty provision in the lease." 12 U.S.C. §1821(e)(4)(B). And, for the period between the appointment of the conservator or receiver and disaffirmance, a landlord can only claim rent consisting of "fixed, regular, periodic charges" (which excludes things such as structural repair costs). *First Bank National Association v. FDIC*, 79 F. 3d 362 (3d Cir. 1996). Here again, the landlord is treated better in bankruptcy, since the bankruptcy trustee must perform essentially all of the obligations of the tenant under the lease until the lease is in fact rejected.

To make matters worse, the FDIC has no specific time within which to affirm or repudiate a lease. In a bankruptcy, the trustee must decide whether to assume or reject a commercial real property lease within 120 days, with the possibility of one 90-day extension for cause (although there is currently some discussion about "reforming" that aspect of bankruptcy law by giving trustees more time to assume or reject leases). By contrast, under the FDIA, the FDIC has a "reasonable period" following its appointment to determine whether to disaffirm the contract or lease. 12 U.S.C. §1821(e)(2). What constitutes a "reasonable period" will depend on the facts of a given situation, making it hard for a landlord to object to delays, or to know when to start seeking a replacement tenant. And if the take-over process involves the appointment of a conservator and then a receiver, ***both*** have an independent right to disaffirm the lease, even if they are the same entity.

Disaffirmance is more than a theoretical possibility. For example, the FDIC took over control of

Washington Mutual Bank (WaMu) on September 25, 2008. Shortly thereafter, it entered into a purchase and assumption agreement with JPMorgan Chase Bank (Chase), under which Chase agreed to purchase the assets of WaMu. That agreement gave Chase the right to decide which of the WaMu leases it wished to assume. The remainder was disaffirmed by the FDIC.

We are not aware of any tool or strategy that can be used to ameliorate the risk that a lease will be disaffirmed after an FDIC takeover. All we can suggest is that if you are considering leasing to a depository institution, or buying property in which a depository institution is a tenant, your due diligence into the financial condition of that tenant must be even more thorough than normal.

Indeed, even letters of credit are at risk if the issuer is taken over by the FDIC. Many landlords are the beneficiaries under letters of credit provided by their tenants as security under their leases. Letters of credit have traditionally been favored by landlords, as the "independence principle" ensures that they can be drawn upon even if the tenant goes into bankruptcy. But under the FDIA, the FDIC has the right to repudiate certain contracts of failed financial institutions. This right extends to letters of credit. Such a repudiation would render a letter of credit valueless, and would likely strip the affected landlord of most or all of its security with respect to a given lease. This is not a new legal development; the 1989 amendment to the FDIA permitted the repudiation of these contracts. However, while financial institutions have faced periods of difficulty and failure since then, the scope of the current downturn has rendered the lending community vulnerable to an unprecedented degree, increasing the likelihood of lender failures and consequent dishonor of significant numbers of letters of credit.

Little can be done to limit this risk with respect to existing letters of credit. But, as increasing numbers of tenants seek rent reductions and other relief, landlords will be presented with opportunities to strengthen letter of credit provisions in their leases (for example, by increasing the financial requirements of permitted issuers; allowing a landlord to draw upon a letter of credit if the issuer fails to meet capital requirements imposed by law; has entered into a supervisory agreement with a federal or state governmental authority; or the issuer's credit rating falls below a specified level). Landlords should be alert to situations that may allow them to demand modifications to letter of credit provisions. And those landlords fortunate enough to be signing new leases should ensure that they impose high standards for issuers (as well as other protections) if those leases require letters of credit as security.

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