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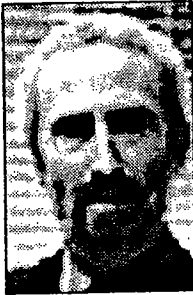
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Sorry, the Check's *Not* in the Mail

Protect your rent stream and security deposit when a tenant becomes insolvent

BY MATTHEW J. SHIER

The reality that the recession likely will not be short-lived has crept into the consciousness of even the most optimistic commercial landlord. As a result, owners have shifted focus from maximization of rental income to maintaining occupancy by credit tenants and controlling operating expenses. But even the most creditworthy tenant is capable of imploding, virtually overnight. A landlord, therefore, must re-evaluate its ability to calculate and recover damages from a terminating tenant and assess the timing and likely terms of reletting affected premises in the event of lease termination.



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Appreciating the Worst-Case Scenario

First and foremost, a landlord must appreciate the applicable limitations and potential exposure in the case of a bankrupt tenant. This risk assessment involves limitations on damages recoverable under the lease, possible loss of some or all of the security deposit and "domino" loss of other tenants and inability to relet space.

Under Section 502(b)(6) of the Bankruptcy Code, if a tenant rejects [terminates] its lease, the landlord is entitled to recover its pre-bankruptcy contract rent and related charges, actual post-bankruptcy rent incurred until lease rejection and a limited portion of the future rent payable under the lease.

Depending on the circumstances of the case, recoverable future rent is capped at between one and three years' contract rent. In the case of a rejected long-term lease in a market in which the supply of space greatly exceeds demand, a landlord stands to recover a mere fraction of its breach damages — if the value of the tenant's unencumbered assets is sufficient to pay that amount.

When a tenant has obtained financing for its business from an institutional lender, there likely are few, if any, unsecured assets from which a landlord may recover in bankruptcy. It is not uncommon that the already limited amount of the landlord's claim therefore receives only "pennies on the dollar."

Many landlords fail to appreciate whether, and to what extent, any security that was deposited with them in better times actually secures a tenant's obligations under its lease. While a landlord holding a standby letter of credit has a high likelihood of realizing the full benefit of that security, holders of cash security (which many landlords prefer) could be in for an unpleasant surprise.

Section 1950.7 of the California Civil Code arguably limits the application of a cash deposit to a tenant's defaults in the payment of rent under the lease, charges for repairs, cleaning and related matters on termination of the tenancy. Future rent damages may not be payable from the deposit and, if not, a landlord may be required to pay the "unused," i.e. nonrecoverable, portion of the cash deposit to the tenant's bankruptcy trustee for payment to other creditors.

A bankrupt tenant's vacating of its premises not only creates a diminution in a landlord's cash flow but also may precipitate other tenant lease rejections or, at a minimum, demands for lease restructurings. When vacancies increase within a property in a recession, the market notices immediately, and tenants often are emboldened to renegotiate their rents.

A landlord who attempts to stem the tide of threatened vacancies by restructuring leases without a well-planned overall strategy exacerbates rather than reduces the problem. Once a property or an owner appears distressed in the place, it invariably triggers additional problems and, in turn, additional vacan-

Pre-Crisis Assessment

Any landlord confronted with a tenant experiencing financial difficulties should conduct an immediate objective analysis of the situation. In addition to the form and amount of any security deposit, the landlord should assess the following key matters:

If a landlord has obtained financial information from the tenant at the time the lease was executed, that information should be reviewed carefully to ascertain the general nature and extent of its assets and liabilities.

More important, even if the lease does not require the tenant to provide current financial data, such information, preferably certified by the tenant, should be a landlord's first request in response to a tenant seeking lease re-negotiation.

Credit rating and reporting agencies and other sources of financial information should be contacted early in the process, not just to verify the tenant's pleas but also to enable a critical analysis of the likely degree of success of the landlord's claim against the tenant in bankruptcy.

Once this assessment has been conducted for any tenant, a landlord is well-advised to perform the same analysis for all tenants in the building — even if they have not yet approached the landlord concerning a lease renegotiation. Every tenant is at least thinking about it, and this advance preparation enables a landlord to respond, or to initiate protective action, decisively.

A landlord should review the "bankruptcy clause" in all of its leases. This provision is typically one of many that address actions that constitute tenant default under the lease.

While a lease provision that deems the voluntary or involuntary bankruptcy of the tenant a lease default is not enforceable under 11 U.S.C. Section 365, other economic default criteria often included in such clauses — for example, the insolvency of the tenant or the tenant's inability to pay its debts as they become due — are enforceable.

If a landlord is able to assert an enforceable default before the tenant has filed a bankruptcy petition, it can enhance significantly its pre-bankruptcy claim, which is far more likely to be paid in bankruptcy.

Implementing an Action Plan

Once the pre-crisis assessment has been completed, a landlord should explore alternatives, including a restructuring of the lease, with any tenant experiencing financial difficulty. With success, the tenant will remain in the building, helping to stem a "domino" effect and to keep the rent flowing, albeit reduced. In exchange for concessions on the rent (and

possibly the term), a landlord should explore with its tenant the following lease modifications:

- *Rent.* Any reduction in rent should be structured as a moratorium on payments of the contract rent, rather than an unconditional lowering of the stated rental, and

the differential should be accrued at an appropriate interest rate.

A provision should be included allowing the landlord to review the tenant's financial condition periodically to determine whether and when the moratorium on contract rent should be discontinued or reduced.

Most important, the amendment should provide that any default by the tenant under the amended lease immediately terminates the rent moratorium and restores the original contract rent. This insures that, if the tenant ends up in bankruptcy, the landlord will be able to claim its original lease damages.

- *Security deposit.* The security deposit provision should be amended to provide that the deposit will secure all of the tenant's obligations under the lease, including future rent damages for breach of the lease, and granting landlord a security interest in the deposit.

Alternatively, the deposit simply could be paid over to the landlord in consideration of the concessions on the rental amounts.

Finally, the security deposit language should be expanded to clarify that the Section 1950.7 limitations operate only if the tenant is not in default under the lease.

- *Bankruptcy clause.* The bankruptcy clause should be revised to provide that certain acts by the tenant short of the commencement of a bankruptcy proceeding — for example, failure to pay any monetary obligation in excess of \$2,500 to any creditor on or before its due date or the restructuring of any existing debt obligation, at landlord's election — constitute a default under the lease. Such language provides the landlord with some leverage in the event that the tenant continues to flounder or ultimately files bankruptcy.

Challenging times demand creative solutions. Rather than simply hoping it can dodge the economic bullet, a landlord can take action to maintain cash flow and minimize vacancies. Few tenants are immune to the effects of the recession. Some landlords wait until a tenant or two has filed bankruptcy, but the proactive owner realizes that such action is often too little, too late.