How to Structure a Lease to Protect Against the Risk of a Bankruptcy of the Tenant

by Susan Fowler McNally, Carter H. Klein & Michael S. Abrams

ABOUT THE AUTHORS

Susan Fowler McNally *is a partner at Gilchrist & Rutter Professional Corporation, Santa Monica, California, where her practice focuses on real estate transactions, including purchases and sales; commercial and retail leasing; secured and unsecured financings; telecommunications licenses and service agreements; and construction, design professional, and consultant contracts. McNally is a frequent author and speaker for bar association publications, meetings, national conferences, and seminars.* [redacted]

Carter H. Klein *is a partner with Jenner & Block, LLC, Chicago, where his law practice focuses on*

(Continued on page 45)

The recent downturn in the economy has resulted in greater volatility in the financial status of many tenants, thus compelling landlords entering into office leases with these tenants to accept far greater risks than they are accustomed to. Due to the unconventional nature of the tenant improvements that many of these tenants require (*i.e.*, dot.com and high-tech tenants), their premises may not be readily re-leasable if they default. This article will explore how landlords can reduce the risks involved in leasing space to such tenants.

Landlords generally prefer to enter into leases with creditworthy tenants (*i.e.*, tenants with high and demonstrable net worth, substantial tangible assets, and a long track record of successful operation). Start-up companies generally do not have significant net worth, but they usually do have a significant burn rate (*i.e.*, the rate at which they burn though other people's money, whether angel financing, venture capital, or money raised through a public offering). When the financial status of a tenant is extremely volatile, the risk of a lease default increases. Dot.com tenants usually have no tangible assets and their operating histories cover a span of months (if not weeks) rather than years. The tenant improvements preferred by most high-tech tenants are unconventional and many (especially Internet and telecom-related companies) require significantly greater electrical and air conditioning

capacity than traditional office tenants. Landlords attempting to re-lease high-tech premises after an early termination due to a tenant default may find themselves spending substantial sums of money to alter the premises for a more traditional tenant's use.

To induce landlords to accept the risks associated with renting to tenants whose long-term financial stability is questionable, many such tenants offer various credit enhancements, the most widely accepted of which are cash security deposits, personal guaranties, and letters of credit. Historically, the most typical forms of security accepted by landlords have been cash security deposits and prepaid rent. Both have certain limitations under bankruptcy and state laws. To understand these limitations, and to appreciate the advantages of letters of credit, it is necessary to understand how a landlord's claims against a tenant in bankruptcy are treated by the bankruptcy court.

§ 362(a) of the Bankruptcy Code provides for an automatic stay or injunction against creditors taking various types of actions affecting the debtor or its property. The stay issues automatically from the moment the petition for bankruptcy is filed by or against the debtor. The automatic stay prohibits creditors from taking possession or otherwise obtaining any property of the debtor, enforcing a lien against the debtor's property, or continuing any litigation against the debtor, after the debtor has filed for or become the subject of bankruptcy proceedings and until the bankruptcy court grants relief from the automatic stay. A landlord's claims against a tenant in bankruptcy are treated differently based on whether the tenant assumes or rejects the lease. If the tenant assumes the lease, the lease is reinstated and the landlord is paid all arrearages. If the tenant rejects the lease, the landlord's claims are subject to a statutory cap.

During the period commencing on the bankruptcy filing date and continuing until the debtor's assumption or rejection of the lease (the "**Post Petition Period**"), the debtor is required to perform all of its obligations, including paying the rent, in a timely manner.

Under § 365 of the Bankruptcy Code, the trustee or tenant/debtor in possession ("**debtor**") must either assume or reject the lease within 60 days of the bankruptcy filing date; however, the court may grant one or more extensions of the 60-day period and routinely does so. A landlord may oppose an

A landlord's claims against a tenant in bankruptcy are treated differently based on whether the tenant assumes or rejects the lease. If the tenant assumes the lease, the lease is reinstated and the landlord is paid all arrearages. If the tenant rejects the lease, the landlord's claims are subject to a statutory cap.

extension of the time period, or move to compel the debtor to assume or reject the lease; however, unless the debtor is in default with respect to its Post Petition Period lease obligations, the landlord is unlikely to prevail.

The landlord is entitled to an administrative claim (*i.e.*, a claim that gets paid before the claims of other unsecured creditors) for any default by the debtor during the Post Petition Period. The landlord may also obtain a bankruptcy court order compelling the debtor to immediately pay all defaulted amounts incurred during the Post Petition Period. This is the case even if the debtor has insufficient funds to pay all other administrative claims in full, such as those of the debtor's attorneys and other professionals.

In order to either assume the lease, or to assume and assign the lease to a third party, the debtor must cure all existing defaults and provide adequate assurance of future performance under the lease. The two principal issues between debtors and landlords over the assumption and assignment of leases are (1) what defaults exist and the amount of money or other actions necessary to cure the default and (2) whether the debtor's or its assignee's financial condition is sufficient to demonstrate adequate assurance of future performance. Generally, with respect to adequate assurance, the court will permit an assignment of the lease if the assignee's financial position is substantially comparable to that of the debtor's at the time the debtor entered into the lease.

If the debtor assumes a lease and subsequently defaults under the lease or rejects it, the landlord is entitled to treat the landlord's entire damage claim as an administrative claim in the bankruptcy case. If the debtor rejects the lease, or the lease is deemed rejected because the debtor failed to assume the lease within the 60-day period, it will constitute a breach of the lease immediately before the date of

the filing of the bankruptcy case and the landlord will be entitled to assert a pre-petition claim for damages resulting from the breach. The landlord's lease rejection claim is first calculated under the lease and state law. The allowed amount of the claim is, however, subject to the cap set forth in § 502(b)(6) of the Bankruptcy Code.

Bankruptcy Code § 502(b)(6) provides that the maximum allowable claim of a landlord for damages resulting from the termination of a lease of real property may not exceed:

> A). the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease, following the earlier of—
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the lease property, plus,
>
> B). any unpaid rent due under the lease, without acceleration, on the earlier of such dates;

Although the cap on its face appears to be a straightforward calculation, the maximum allowed by the bankruptcy courts is uncertain and varies by jurisdiction. The issues open to interpretation include (a) which of the landlord's claims are subject to the cap; (b) what is the rent reserved which is included in the calculation of the cap; and (c) how is the 15 percent limitation calculated.

Bankruptcy Code § 502(b)(6) splits the landlord's claims into two parts, unpaid pre-petition rent and the balance of the landlord's claims under the lease. The landlord's entire claim for unpaid rent due on the earlier of (1) the date of filing of the petition, or (2) the date the landlord repossessed (or the debtor surrendered) the property, is not capped. The determination of the date of repossession or surrender, if earlier than the filing date, is made under state law. It is important to note that landlord is entitled only to the unaccelerated amount owed on the applicable date. Thus, even if the landlord has obtained a state court judgment against the tenant for the entire amount owed under the lease prior to the filing of the bankruptcy case, the landlord's allowed claim in the bankruptcy case will be reduced to the capped amount.

Courts are divided as to whether the cap applies to all damage claims of the landlord other than unpaid pre-petition rent. Almost every court will apply the cap to items designated in the lease as rent or additional rent and to the tenant's obligations to restore the premises at termination of the lease. The majority of courts have found that the cap applies to all damages resulting from the rejection of the lease and the tenant's breach or nonperformance of any covenants or conditions under the lease. Under the majority view, in addition to unpaid rent, damages subject to the cap include pre-petition claims for repair and maintenance costs. Conversely, the minority view holds that the cap only applies to damages directly resulting from the termination of the lease and, therefore, repair and damage claims are not capped.

Interesting questions arise as to whether the landlord's claim against the debtor's bankruptcy estate arising in connection with the lease are for rent reserved under the lease and therefore are subject to the §502(b)(6) cap. Are real estate taxes, insurance premiums, and tenant's maintenance obligations part of the "rent?" How about attorneys' fees? What about build-out costs paid by the landlord, but amortized over the life of the lease? The answer to these and related questions is not found in §502(b)(6) itself, and will turn on the facts of each case, the language of the lease, and whether the claimed damages arise from the tenant's failure to pay for charges which are by their nature regular, fixed, and periodic.

Pursuant to Bankruptcy Code § 502(b)(6), a landlord's damages are calculated by using a formula that references the lease itself, specifically the "rent reserved by such lease." The meaning of the phrase "rent reserved by such lease" has given rise to a large amount of litigation, with courts applying three different tests. In the first test, a charge in a lease is included as rent reserved if it is expressly labeled as rent in the lease and is payable in fixed, regular, or periodic amounts. The second test expands the first test by including as a third factor whether the questionable charge relates directly to, or increases the value of, the property. The third test is set forth by the Bankruptcy Appellant Panel for the Ninth Circuit in *In re McSheridan*, 184 B.R. 91 (9th Cir. B.A.P. 1995). The McSheridan test provides that in order to be "rent reserved" a charge must be:

1. either (a) designated as "rent" or "additional rent" in the lease; or (b) provided as the tenant's obligation in the lease;
2. related to the value of the property or the lease thereon; and
3. properly classified as rent because it is a fixed, regular, or periodic charge.

The first and third prongs of the *McSheridan* test are relatively straightforward. If the charge is not designated as rent or specifically stated to be the tenant's obligation or is not fixed, regular or periodic, then it is not "rent reserved." Most of the litigation involves whether the charge relates to the value of the property. Courts have not been uniform in their application of this prong of the test. However, most courts include payments for insurance, common area charges, and taxes within "rent reserved." Utilities and repair and maintenance obligations generally are not included within the "rent reserved."

Courts are split over how to calculate the amount under the 15 percent limitation. Under the majority rule, the limitation is calculated by taking 15 percent of the total rent payments due under the remainder of the lease term. The minority view calculates the 15 percent limitation to the amount of time remaining under the lease. The difference between the two becomes significant when the lease provides for substantial rent increases over time.

Under common law, a landlord had the option of terminating the lease and seeking to obtain possession of the premises or keeping the lease in effect and suing for damages for each periodic default under lease. The common law has been modified in virtually every state. Under state law, landlords typically may recover an amount equal to the net present value of future rents due under the lease, plus any rent not yet paid at the time of termination of the lease.

One significant difference in state law is that certain states, such as California, impose an obligation on the landlord to mitigate its damages. Thus, under California law, the landlord's damages would be reduced by the net amount the landlord could recover by releasing the property to a third party after taking into account the costs incurred in releasing the property. Other states, such as New York, do not impose any duty on the landlord to mitigate its damages. Since a landlord's allowable damages in bankruptcy are calculated in the first instance by state law, a California landlord's damages would be reduced by any amount the debtor shows could have been reasonably mitigated by the landlord while the New York landlord's claim will not be so reduced.

In bankruptcy, a tenant's cash security deposit is an asset of the debtor's bankruptcy estate. To the extent that the cash security deposit exceeds the allowed claim of the landlord, the excess will be payable to the bankruptcy estate. Additionally, the landlord is required to obtain relief from the automatic stay in order to set off the security deposit against the landlord's damages.

It is not uncommon for landlords to require guaranties from the principals of the tenant. However, in many, if not most instances, the guaranty is either not available or is of limited value if the tenant fails.

Several states also place limitations on the use of security deposits. Often, a landlord may only apply the security deposit to the payment of rent, the costs to repair damage to the premises caused by the tenant, and the costs to clean the premises upon termination. The landlord may further be required to return any unapplied portion of the security deposit to the tenant within a short period of time (*e.g.*, 30 days after termination). Thus, under state law, the security deposit may not be available to offset all of the landlord's actual damages.

Prepaid rent generally is treated like a security deposit under both state and bankruptcy laws. However, at least one bankruptcy court has held that the prepaid amount of future rent may not be set off against the landlord's damages and such amount must be turned over to the bankruptcy estate.

It is not uncommon for landlords to require guaranties from the principals of the tenant. However, in many, if not most instances, the guaranty is either not available or is of limited value if the tenant fails. When leasing to start-up companies, there is rarely a credit-worthy party willing to provide a guaranty. The founders of the tenant often have little net worth separate and apart from their interest in the tenant and the venture capitalists and other financial backers of the company will not provide their credit to the landlord.

A guaranty is worth pursuing if there is a credit-worthy party (ideally one whose assets are located in the state in which the premises are located) willing to sign one because the limitations of Bankruptcy Code § 502(b)(6) do not limit a landlord's claim against a non-debtor guarantor unless the guarantor is himself in bankruptcy. The purpose of Bankruptcy Code § 502(b)(6) is to limit the amount

of damages a commercial landlord is allowed to recover from a debtor's estate so other creditors' claims will not be inordinately diluted by landlord's claim for breach of a long-term commercial lease. That being the case, the purpose of the statute is not served by applying its limitations to guarantors whose assets are not property of the debtor's estate. Courts that take this position, however, have not addressed the guarantor's subrogation rights and indemnity claims. Nevertheless, the cases that have addressed the issue have all held that the non-debtor guarantor liability to the landlord is not capped by §502(b)(6).

Remember too that a guaranty is subject to all of the surety defenses unless a landlord has obtained appropriate waivers of those defenses. One such defense is that any modification of the primary obligation exonerates the surety. Thus, if the landlord has entered into any extension agreement, lease modification, or workout with the tenant without the guarantor's written consent, the guarantor may be released from liability. Since most guarantors will not be willing to consent to any lease modification that will increase the likelihood that the guarantor will be called upon to pay the rent and perform the tenant's other obligations under a lease, a prudent landlord should require a guarantor to authorize the landlord to enter into agreements with the tenant to amend, modify, or supplement the lease, from time to time, without being obligated to give the guarantor notice of such modification.

For a relatively small fee (generally 1 percent per annum), a tenant may be able to apply for and have its bank issue to its landlord a letter of credit ("**LOC**") to secure the tenant's obligations under a long-term lease.

From the tenant's perspective, a LOC may be preferable to a large security deposit. A LOC will not necessarily tie up large amounts of the tenant's cash or other liquid collateral as would a security deposit. Instead, the cash can be deployed as working capital in the tenant's business.

From the landlord's perspective, a LOC may be preferable to a security deposit because a LOC is an independent obligation of the issuer. As long as conforming documents specified by the terms of the LOC are presented to the issuer before the expiration date and no fraud is involved, the issuer must honor the draw. When a LOC is utilized, the credit of the issuer stands behind the obligation of the tenant. Even if the tenant is insolvent and/or bankrupt, the issuer still must honor the beneficiary's conforming draws. Moreover, even if the tenant disputes the landlord's claim that the tenant has defaulted in its lease obligations or disagrees with landlord's determination of the amount of damages owed, the landlord can still draw on the LOC. The parties must argue about or litigate the tenant's claims outside of the draw and without involvement of the LOC issuing bank.

The strongly worded rule in Revised Article 5 of the Uniform Commercial Code ("**UCC**"), which deals with letters of credit, is that a draw under a LOC cannot be enjoined unless the applicant can show egregious fraud and all the conditions entitling the applicant to equitable relief have been fulfilled. Those conditions may include showing probable success in proving fraud, irreparable harm, no adequate remedy at law, balance of the equities, and the public interest will be served. In appropriate cases, a bond must be posted by the applicant to preserve the rights the landlord will lose if the LOC draw is enjoined and the credit expires. Appellate case law follows the statute; thus it is very difficult to enjoin a draw on a LOC.

The type of LOC used to secure lease obligations is usually a standby LOC, as opposed to a documentary or commercial LOC used to pay for goods purchased in international trade. A standby LOC is meant to be drawn upon only if a default occurs and is certified by the landlord in a document which is called for by the LOC and presented to the issuer. Besides Article 5 of the UCC, there are two principal regimes which govern letters of credit in this country: the Uniform Customs and Practice for Documentary Credits promulgated by the International Chamber of Commerce effective January 1, 1994, and found in ICC Publication No. 500 (the "**UCP**"), and the International Standby Practices 1998, promulgated jointly by the Institute for International Banking Law and Practice and the International Chamber of Commerce, effective January 1, 1999, and found in ICC Publication No. 590 (the "**ISP**").

From the landlord's perspective, as beneficiary, the preferred governing regime for a LOC should be the ISP. It is specifically designed for standby letters of credit, has clearer rules on questions involved in standbys, including assignment of proceeds and transfers of the LOC itself, and avoids several traps for the unwary found in the UCP. Those traps include (i) if the issuer is closed while the LOC expires due to a force majeure event, the beneficiary cannot effect a draw; (ii) if installment drawings are

contemplated and one is not made, the beneficiary cannot make subsequent drawings; (iii) if transport documents are to be presented, they must not be stale; and (iv) documents cannot be inconsistent with one another. Under the ISP, each of these troublesome pitfalls is eliminated. For example, if the issuer is closed when the LOC expires due to a force majeure event, the beneficiary under an ISP governed LOC has an additional 30 days to make a presentment from the day the issuer reopens. By incorporating the ISP into a LOC, there is no need to worry about drafting additional terms in the LOC to avoid the pitfalls contained in the UCP. If you request them, most banks will issue standbys governed by the ISP.

A landlord is better able to make an error-free draw if the LOC it receives from the tenant's bank (1) calls for few documents; (2) minimizes the verbiage in the documents to be presented; and (3) does not require the wording of the draw documents specified in the LOC to be verbatim or exact language.

The simplest form of presentment is a draft or demand without any other documents, statements or certificates accompanying it. It is also the most difficult presentment to enjoin and is the easiest presentment to comply with without making a mistake. For avoiding the applicability of the automatic stay in bankruptcy, as discussed below, presentment of only a draft or demand is desirable from the landlord's point of view because it does not require declaration of a default or certification that notice of default or demand for payment has been given to the now-bankrupt tenant.

Other drafting tips include: (a) avoiding, as a draw condition, presentment of any document that must be signed by the tenant, a court, or an arbitrator or any third party over which the landlord has no control; (b) permitting the landlord to make partial draws on the LOC; and (c) avoiding any requirement that the landlord be required to specify the use or deployment of the funds drawn. Optimally, the LOC should have an outside or final expiration date beyond the expiration of the lease to allow the landlord to calculate and recover damages to the premises, holdover rent, and avoid or protect against a bankruptcy of the tenant within 90 days of the last payment received under the lease, if received late. The latter concern would dictate (i) requiring expiration of the LOC be more than 90 days beyond the last anticipated payment date, and (ii) using a claw-back provision in the LOC or lease (*i.e.*, a provision which permits the beneficiary to draw on the LOC and hold the proceeds in escrow for as long as is necessary to protect against any preference claim if the tenant files for bankruptcy within 90 days after the expiration of the lease term).

The landlord should check the creditworthiness and acceptability of the issuing bank. Bank rating services are available to determine the strength and acceptability of the issuer. ...If the credit strength of the issuing bank is questionable, consideration should be given to obtaining a confirmation from a reputable money center bank.

Under the UCC, the UCP, and the ISP, if the LOC specifies no time period in which the issuer has to examine and honor, the issuer has a reasonable time, up to seven business days, to do so. Consider revising the LOC to shorten the time period for the issuer to honor to three business days.

Unless the LOC otherwise specifies, originals of each document called for by the LOC must be presented; consequently, copies or fax-signed documents will not comply. To facilitate draws (especially if the issuer is located out-of-state), have the LOC specifically permit draw documents to be presented by telecopy. The LOC should specify the issuing bank's telecopier number to be used for presentment of draw documents by fax.

Presentment letters of credit require the original LOC, including all amendments, to be presented with the documents required to be presented by the terms of the LOC to effect a draw. Although requiring presentment of the original may provide the issuer with some assurance that it is dealing with the true beneficiary, and for multiple draws, allow it to make a notation of the amount drawn on the LOC to help it prevent overdrafts, from the beneficiary's standpoint there is no reason to make presentment of the original LOC a requirement for a draw, except to assist the landlord's lender in obtaining an assignment of proceeds of the tenant's LOC. If the original LOC is lost or destroyed, then the landlord may be unable to effect a draw. Copies are not permitted as substitutes for the lost original and the issuer is under no obligation to issue a duplicate original. Neither the UCC nor the UCP even have a rule dealing with lost originals.

Although the ISP has such a rule, the issuer is not required to replace the original, but may do so in its discretion and on terms protective of it.

Under Revised Article 5 of the UCC, a beneficiary can require an issuer's consent to an assignment of proceeds if the original LOC is exhibited and the LOC is a presentment credit. If the LOC is not a presentment credit, then neither the landlord nor its lender can insist on the issuer's acknowledgment to an assignment of proceeds if the issuer refuses.

Avoid certificates which must be signed by specific individuals. In one case, an individual landlord had died and his personally-signed certificate was required to effect a draw on a LOC securing a tenant's lease obligations, which of course could not be supplied. The court upheld the issuer's right to dishonor. However, note that both the UCC and the ISP permit transfers by operation of law, so a bankruptcy trustee, receiver, decedent's estate, or successor by merger or name change is permitted to make a draw on a LOC of its predecessor even though the LOC is not transferable. Such rule does not extend to asset sales or other consensual or contractual transfers of the LOC unless the LOC is expressly made transferable and the terms of transfer are followed.

Except for transfers by operation of law, a LOC is not transferable unless it expressly so states. If the landlord sells the leased premises, its transferee will want all letters of credit, as well as any cash security deposits, transferred to it. The landlord's lender may also insist on a transfer of the landlord's letters of credit. Accordingly, each LOC should be designated as transferable. To facilitate transfer, the LOC should refer to and contain as exhibits the form of transfer notice and acknowledgment, and specify the transfer fee and who is obligated to pay any transfer fees.

Most letters of credit are issued for a term of one year or less. Banks have regulatory, prudent lending, and capital adequacy concerns about issuing longer term letters of credit. Leases frequently have terms in excess of one year. To bridge the gap between the need of the issuer to keep the expiration date of its LOC limited to a one-year period, and the landlord's need to keep the LOC in place for the duration of the lease, an automatic renewal provision should be included in the LOC. Such a provision will state that the LOC is deemed to be automatically renewed for additional one-year periods unless the issuer notifies the landlord/beneficiary a certain number of days prior to the expiration date (say 60 days) that the LOC will not be renewed. Unless timely notice of nonrenewal is given by the issuer, the LOC will automatically extend for one-year periods until an ultimate outside expiration date, if one is stated, or a cancellation and surrender of the LOC is agreed to by the beneficiary.

If notice of nonrenewal is given by the issuer before the lease terminates, the LOC should also provide that the landlord can draw on the LOC by submitting a document that states that the issuer failed to renew the LOC in a timely manner. For automatic stay considerations, the renew or draw provision should be drafted as an independent ground for the draw, apart from any other default under the lease. If the lease makes the failure to renew the LOC a set number of days prior to expiration of a default under the lease, then the landlord must decide whether it wants to terminate the lease and exercise its remedies or simply hold the draw proceeds as it would a cash security deposit and continue with the lease.

The agreement dealing with what a landlord will do with early expiration draw proceeds will usually be contained in the lease. Typically, some kind of escrow or security deposit arrangement will be negotiated, although some leases merely provide that such funds become the landlord's property and thus, are arguably treated as liquidated damages for the default; however, if the draw proceeds are excessive compared to the landlord's actual damages, it is likely that such "liquidated damages" will instead be treated as a penalty. More often, the parties agree on the landlord's escrowing proceeds of a draw on the LOC for failure to renew or they agree that the landlord will hold them in a segregated account under its sole control, but subject to the contractual obligation to apply them to the lease obligations in the event of a default.

The landlord should check the creditworthiness and acceptability of the issuing bank. Bank rating services such as Thompson's Financial BankWatch are available to determine the strength and acceptability of the issuer. While many foreign banks are as strong, or stronger than U.S. banks, convenience for presentment and enforceability and jurisdiction concerns in the event of a dispute dictate that at least a U.S. branch of a foreign bank be used. If the credit strength of the issuing bank is questionable, consideration should be given to obtaining a confirmation from a reputable money center bank.

If presentment of documents is allowed to be made by telecopier, the location of the issuing bank is important, more as a matter of convenience and logistics, although it can be important if suit must be threatened or brought against the issuing bank for wrongful dishonor. Obviously, the landlord would prefer to litigate in its own jurisdiction rather than in a distant city, state, or country. If original documents must be presented, then time and convenience favor use of a bank located in the vicinity of the landlord.

Under §362 of the Bankruptcy Code it may make a difference how the draw conditions are worded. If one of the draw requirements is that the landlord declare a default under the lease and make a demand on the tenant for payment of unpaid rent or other amounts due under the lease, the landlord may be violating the automatic stay by sending the tenant a notice of default while the tenant is in bankruptcy. Consequently, it is important to draft the draw trigger in a LOC so that the landlord need only state that a default has occurred under the lease (and not require a statement that notice of the default was delivered to tenant). Additionally, the lease should be drafted to make it clear that landlord is not required to deliver notice of default to tenant where landlord is barred by applicable law from sending tenant a notice of default.

If, as a precondition of a right to draw, the landlord must make demand on the tenant for payment of amounts in default, the landlord may or may not be held in contempt for violating the automatic stay. This depends upon whether or not the court determines the notice was merely informational for purposes of alerting the tenant and permitting a draw and was not really meant to be a coercive demand for payment. The astute landlord's attorney will avoid drafting into the lease or the LOC, the requirement for a landlord's demand of any type of payment as a precondition, directly or indirectly, for any draw on the LOC, at least at a time when the tenant is in bankruptcy.

No cases have decided the issue of whether the proceeds of a LOC securing a tenant's lease obligations which is drawn upon after the tenant's bankruptcy can be applied against those obligations in amounts in excess of the §502(b)(6) cap. Should the §502(b)(6) cap be applicable to prevent draws from a LOC to be applied against lease obligations in amounts in excess of the cap?

Because there is no case precedent, a bankruptcy court could take the position that once the draw has been effected, the cash proceeds can be applied by the landlord against the tenant's obligations only to the extent of the cap. The debtor could argue that the excess is in the nature of a penalty or unreasonable amount and it is against public policy, as embodied in §502(b)(6), for the landlord to keep the excess. The debtor would argue any such excess should be disgorged and returned to the debtor's estate. Additionally, if it is the tenant which is the applicant for the LOC, then the tenant will have to reimburse the issuer for the full amount of the draw. If the draw by the landlord is in excess of the cap amount, the issuer will have a claim against the debtor's estate or collateral for the full amount of the draw, thus depleting the estate by amounts in excess of the §502(b)(6) cap. Debtors would argue that avoidance of such depletion is the purpose for which §502(b)(6) was enacted; thus, the purpose of §502(b)(6) is frustrated if the cap is not applied to recoup the excess draw proceeds.

A landlord's secured lender should take a keen interest in the landlord's rights in and to security deposits pledged by the landlord's tenants to secure their lease obligations.

The better answer, however, is that the cap does not apply to preclude the landlord from using LOC proceeds to satisfy its state-law damages, even if they are in excess of the §502(b)(6) cap. A standby LOC is an independent obligation of the issuing bank, a non-debtor. If a guarantor cannot avail itself of the cap of §502(b)(6), a fortiori, neither should an issuing bank. Because of the strong independence principal embodied in the law of letters of credit, draws on letters of credit have typically been immune from various bankruptcy protections which benefit the debtor or its unsecured creditors. The cap on damages under §502(b)(6) should be treated no differently.

A landlord's secured lender should take a keen interest in the landlord's rights in and to security deposits pledged by the landlord's tenants to secure their lease obligations. If the lease security is in the form of a LOC, the secured lender to the landlord will want to (i) perfect its security interest in the LOC; (ii) be able to obtain control of the LOC in the event of a landlord default; and (iii) establish a protocol for when the LOC may be drawn upon and how the proceeds of the draw will be used.

Under Articles 5 and 9 of the UCC, (before the enactment of Revised Article 9), the procedure for obtaining a security interest and control over LOC collateral consisted of either having the LOC transferred into the name of the secured creditor if it were transferable, or if it were not transferable, taking possession of the original LOC, obtaining an acknowledgment of assignment of proceeds from the issuer and obtaining pre-executed undated draw documents from the landlord and holding them until an event occurs which entitles both the landlord and the secured lender to draw upon the LOC. In the latter case, the landlord's lender should have been granted authority in the security documents to complete the draw documents, date them, and present them. By having an assignment of proceeds acknowledged by the issuer, the landlord's lender could be assured, assuming the draw documents were compliant, that the issuer would pay them to the landlord's account designated in the assignment.

Lenders and landlords should be aware of the differences between an assignment of proceeds of a LOC and a transfer of the LOC. The former is accomplished by an acknowledgment of the issuer, on a standard form of the issuer, that the assignee is entitled to be paid a designated portion, or all of the proceeds of a draw on the LOC. A transfer of a LOC actually transfers the right to draw on the LOC, sign draw documents, consent to amendments, and make assignments of proceeds. As noted above, a LOC is not transferable unless it is so designated or the issuer otherwise consents to the transfer with the authorization of the applicant. An assignment of proceeds gives the assignee no right to draw on the LOC, and is subject to the rights of prior assignees, transferee beneficiaries, paying and negotiating bank rights, and the set-off rights of the issuing bank.

Under old Article 9 of the UCC, if the LOC were not transferred into the secured lender's name, the landlord's lender could only obtain a security interest in it by taking possession of it. This was true even if the LOC was not a presentment credit. Holding possession of the LOC might beat the bankruptcy trustee in the event of the landlord/borrower's bankruptcy, but such holding alone gave the landlord's lender very little control over when and if a draw would be made, where the proceeds would be deposited, or even to whom the proceeds would be payable if the landlord chose to assign the proceeds elsewhere.

Under Revised Article 9 of the UCC, the landlord's lender can perfect a security interest in LOC rights, *i.e.*, the right to receive proceeds of a draw on a LOC, by obtaining from the issuer an acknowledgment of assignment of the LOC proceeds under UCC §5-114(c). To do so, the landlord's lender must obtain a consent to or acknowledgment of assignment of LOC proceeds from the tenant's issuer. The tenant's issuer need not consent to or acknowledge an assignment of proceeds to the landlord's lender unless the LOC is a presentment credit and the mortgage lender consents to the issuer's reasonable conditions of assignment. Although such an assignment will beat the bankruptcy trustee and the tenant's rights to the proceeds, as noted above, the landlord's lender with an assignment of proceeds but not a transfer of the LOC will be subject to the landlord's decision and ability to make a timely and conforming draw on the LOC and to prior assignees transferee beneficiary rights, rights of confirming, negotiating, and other paying banks, and the right of set-off of the issuer for claims it may have against the landlord.

Under Revised Article 9 of the UCC, mortgage lenders to landlords are at a disadvantage compared to personal property lenders when it comes to perfecting a security interest in LOC rights. A personal property secured lender can obtain automatic perfection in LOC rights without having to go to the trouble of obtaining an acknowledgment of assignment of proceeds from the issuer. The personal property secured lender will have a perfected security interest in LOC rights if it has a perfected security interest in underlying personal property collateral secured or "supported" by the LOC, such as an account, an instrument, a payment intangible, or another general intangible. Revised Article 9 of the UCC provides that a personal property secured lender that has perfected its security interest in the underlying personal property collateral needs do nothing further to obtain a perfected security interest in the LOC rights supporting or securing payment of the underlying obligation, *i.e.*, perfection is automatic. A mortgage lender to the landlord has a mortgage lien on and assignment of rents in the mortgaged premises and the tenant leases. That collateral is not personal property of a type in which a supporting obligation arises under Revised Article 9 of the UCC. Therefore, to obtain a perfected security interest in LOC rights, the landlord's mortgage lender will have to obtain from the issuer an acknowledgment of assignment of the proceeds of the LOC.

If the landlord's lender can obtain neither a transfer of the LOC nor an assignment of the proceeds, in

both cases consented to by the issuer, it may still try to obtain control over the LOC proceeds by the use of pre-signed documents and a payment direction. This method, however, may not always work if the issuer finds out about it and refuses to recognize it or the landlord files for bankruptcy before the draw is made or within the preference period thereafter. The safest procedure for the landlord's lender is still to obtain a transfer of the LOC, which will enable the lender to effect draws, and will put the lender's claim prior to that of other assignees and set-off rights of the issuing bank.

The secured lender to the landlord should realize that it has one year from the effective date of Revised Article 9, which in most states was July 1, 2001, to reperfect its security interest in letters of credit which it perfected by holding possession under old Article 9, of the UCC. If the lender's security interest is perfected prior to Revised Article 9, by holding possession of the original of the LOC, that will no longer be sufficient under Revised Article 9. Instead the lender must obtain an acknowledgment of assignment of proceeds from the issuer within the one-year period, or better yet, obtain a transfer of the LOC into its name. Otherwise, after the one-year period the lender's interest will be unperfected.

Tenants who are unable to pay their rent in a timely fashion frequently threaten to file for bankruptcy if the landlord refuses to restructure their lease obligations. (Generally speaking, tenants want to reduce the size of their premises and/or their rental rate when they are in financial difficulty.) A landlord may be willing to work with the tenant, but should nevertheless be concerned about the risk of the tenant filing for bankruptcy within 90 days after making any payments to the landlord pursuant to any such workout agreement, because such payments may be treated as preferences which are subject to being recovered by the bankruptcy trustee. Thus it is helpful to define tenant defaults broadly to include several precursors to the tenant filing for bankruptcy. Examples of such precursor defaults include:

a. failing to maintain a Web page;
b. tenant making any public announcement that the tenant intends to either (i) cease operations; (ii) dissolve; or (iii) make a distribution of all liquid assets to its shareholders;
c. failing to complete its tenant improvements by a specified date;
d. failing to occupy the premises and commence conducting business from the premises by a specified date;
e. vacating the premises; and
f. failing to obtain the next round of private or public financing prior to a specified date.

Because a LOC is an independent obligation of the issuer and thus a draw upon a LOC is not barred by the automatic stay that prevents landlords from taking various actions affecting a tenant/debtor in bankruptcy, and because a draw upon a LOC is (arguably) not subject to the cap on damages under Bankruptcy Code §502(b)(6), LOCs will remain the security of choice for landlords leasing to tenants whose credit is deemed risky.

Typically landlords pay for the cost of tenant improvements and brokerage commissions and capitalize them into the rent stream. The problem, as discussed above, is that by including these costs in the "rent reserved" they become subject to the cap imposed by Bankruptcy Code § 502(b)(6). To avoid the risk of such sums remaining unpaid if the tenant becomes bankrupt, landlords like to get cash-flush tenants to pay for all of those items the landlord typically goes out-of-pocket for, such as tenant improvements and broker commissions. Consequently, leases with such tenants are frequently drafted to clarify that it is the tenant's responsibility to pay for all of the tenant improvements, as well as the brokerage commissions.

If the tenant is unwilling or unable to pay for such costs upfront, the landlord can lend the tenant a sum of money equivalent to the sum of the tenant improvement costs and brokerage commissions, but the landlord should not amortize the repayment of such loan into the rent stream. Although this will affect the cap rates on the building, most sophisticated buyers are capable of understanding the value of treating the loan for tenant improvements and brokerage commissions as a separate transaction from the lease. This minimizes the risk of non-payment if the tenant files for bankruptcy and can make the appropriate adjustment in determining the fair market value of the building.

The landlord should be careful to document such a loan outside of the lease and treat it as a completely

separate transaction. Such a loan structure should be carefully documented as a secured creditor/debtor relationship to avoid any implication that the sums due under the loan are really rent payments due under the lease and thus are subject to the cap on landlord's claims for damages under the lease. Some landlords go so far as to have one of their affiliates make the loan to the tenant to maximize the likelihood that such a transaction will be treated as being an obligation, independent from the tenant's lease obligations.

In order to properly document the loan as an obligation separate and apart from the lease, the tenant should be required to sign a promissory note and a security agreement. Ideally, the lease should not make any reference to such loan and the lease definitely should not be cross-defaulted with the note and security agreement.

Any loan to a tenant should be collateralized. Since many start-up companies do not own real property or other tangible assets which could serve as collateral for their debts, the security of choice is a LOC. Because the issuing bank's obligation to pay out on a LOC is independent from the tenant's obligation to repay the loan, and is one step further removed from the tenant's obligations under its lease, the transaction should not be subject to bankruptcy or state law limitations on the damages a landlord can recover from a tenant/debtor. However, as is true with most bankruptcy matters, it remains possible that a bankruptcy court could collapse even the most carefully documented loan into the lease under the theory that the loan repayments really reflect costs associated with tenant's use and occupancy of the leased property and thus qualify as "rent reserved." To date, no bankruptcy courts have decide this issue, so transactional lawyers can only hope that documents which clearly reflect the intent that the obligations to repay the loan be treated as separate and distinct from the obligations to pay rent under the lease will be honored.

CONCLUSION

Because a LOC is an independent obligation of the issuer and thus a draw upon a LOC is not barred by the automatic stay that prevents landlords from taking various actions affecting a tenant/debtor in bankruptcy, and because a draw upon a LOC is (arguably) not subject to the cap on damages under Bankruptcy Code §502(b)(6), LOCs will remain the security of choice for landlords leasing to tenants whose credit is deemed risky. REI

ABOUT THE AUTHORS

(continued from page 35)

banking, commercial lending, loan workouts, consumer credit, uniform commercial code, sales, franchising and distribution, and international business transactions. Klein is a member of the Chicago, Illinois State, and American Bar Associations, and is a frequent author in industry publications. [redacted]

Michael S. Abrams *is a partner of Gilchrist & Rutter Professional Corporation, which has offices in Santa Monica and Los Angeles, California. His practice focuses on the representation of creditors and debtors in bankruptcy, reorganization, workouts, and other insolvency proceedings. Abrams has substantial experience representing landlords and debtors in complex real estate workouts and bankruptcies.* [redacted]