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Workshop 8

**Enhance Your Credit:
Lease Guaranties, Security Deposits and Other Performance
Enhancements**

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INTRODUCTION

- In today's retail climate, both landlords and tenants face a myriad of challenges with regard to lease performance.
- Landlords and Tenants have several options available to them when attempting to ensure performance of lease obligations.

Guaranties

General Requirements

- Guaranties provide assurances for performance of lease obligations for both landlords and tenants.
- The guarantor's creditworthiness should be thoroughly assessed.
- While the requirements for a guaranty will vary from state to state, guaranties must generally be in writing and supported by consideration in order to comply with the statute of frauds.
- In addition to the statute of frauds, consider the effect of any applicable fraudulent conveyance statutes.

Guaranties

Type and Scope of Guaranty

Payment and Performance Guaranties

- A performance guaranty will be preferable to a landlord.
- Guaranty of payment v. guaranty of collection

Guarantor Obligations and Caps on Liability

- Guaranties should always be explicit as to the obligations to be guaranteed.
- Obligations under a guaranty may be capped or limited in other ways.
 - Dollar amount
 - Time Period
 - Set obligations (e.g., net worth or gross sales)

Guaranties

Term of Guaranty

Guarantor may limit liability under the guaranty to a set “guaranty period”.

- The guaranty should make clear that the termination does not apply to any tenant default occurring during the guaranty period.
- Guarantors may also terminate the guaranty based upon certain material changes to the lease.
 - Renewal Term
 - Assignment
- Guarantors also limit liability by including “good guy” guarantor provisions.

Guaranties

Defenses for Guarantors

a. Waivers

b. Lease Amendments without Guarantor Consent

c. Assignment and Sublease

d. Waiver of Subrogation and Subordination

e. Tenant Bankruptcy

Security Deposits

General

- The simplest and most typical way for a landlord to secure a tenant's obligations under a lease is to collect a cash security deposit at lease execution.

Security Deposits

Size and Duration of Security Deposits

- A. Landlords should evaluate the assets of the tenant versus the obligations under the lease, as well as the landlord's costs and the time it will take to re-let the premises.
- B. Landlords should consider whether they are willing to allow the security deposit to burn off in whole or in part for good behavior and/or decreasing remaining lease term.

Security Deposits

Lease Provisions Governing Security Deposits

- State law issues governing security deposits.
 - Many states require that security deposits be held in a separate, interest bearing account and that the interest be provided to the tenant.
- Leases should be specific as to when a landlord may apply a security deposit and landlords should 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.

Security Deposits

Creditor's Rights

- In the event that the tenant files for bankruptcy, the landlord should be aware of its rights with regard to retaining the security deposit.
 - Greater of 15% of unaccelerated rents and 1 year of rent
 - Cash security is considered the tenant's asset
- If a tenant is at risk to file bankruptcy, consider whether to offset the security deposit against the amounts owed but be wary of the risk of a claim of preference and risk of clawback, if the tenant does file bankruptcy soon thereafter.

Letter of Credit

General

- 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:
 - Standby Letter of Credit
 - Commercial Letter of Credit
- International Chamber of Commerce has developed two sets of guidelines to use as governing law:
 - International Standby Practices (the “ISP 98”)
 - Uniform Customs and Practices for Documentary Credits (the “UCP 600”)

Letter of Credit

Lease Provisions Concerning Letters of Credit

- The lease provisions should specify when the landlord has the right to draw on the letter of credit.
- The lease should provide that proceeds may be applied against the payment of any rent or other sums and to damages.
- 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.
- If possible, it is good practice to attach the form of the letter of credit as an exhibit to the lease.

Letter of Credit

Letter of Credit Provisions

- The form and wording of the letter of credit itself should be carefully negotiated by the beneficiary so it is simple and does not require any additional documentation, precise wording or evidence of the occurrence of an event of default.
- Presentment should be in person or by fax/overnight mail.
- Allow for multiple draws.

Letter of Credit

Bankruptcy Issues

- Given that the letter of credit is an agreement between the beneficiary and issuing bank, the majority of courts have held that the letter of credit is not a part of the tenant's bankruptcy estate.
 - A cash security deposit would be considered a secured claim in a bankruptcy proceeding, and would be subject to the automatic stay as an asset of the bankruptcy estate.
- Tenants may benefit from having their security deposit held in the form of a letter of credit as well.

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

Introduction – Landlord and Tenant Concerns

- At the outset of the lease term, both the landlord and the tenant face significant risks during the initial construction period.
- These obligations can be secured through escrow accounts, construction bonds, guaranties and letters of credit.

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

Escrow Accounts

- Today, we see tenants, in particular, require such escrow accounts for more ordinary landlord construction allowance situations.
- Escrow agreements can be negotiated to suit the parties' needs.
 - Identity of escrow agent
 - Specificity on draws
- Disadvantages:
 - Can be costly
 - Limited dispute mechanisms

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

Construction Bonds

Leases often require tenants to obtain construction bonds for tenant's work, although how often that requirement is enforced is another question.

I. Completion Bonds

II. Payment and Performance Bonds

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

Self-Help Rights

- Allow tenants both to finish their build-outs and, in certain circumstances, the common area improvements s.
- 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 and be able to seek damages for anything in excess.
- Landlord are usually unwilling to provide self help rights; particularly with respect to common area improvements.

Conclusion

- In these economically insecure times both landlords and tenants have many options to ensure lease performance.
- Each type of security has its own risks and pitfalls, so tenants and landlords should keep all of the benefits and risks of each type of security in mind while drafting leases.



Questions?

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