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# Guaranties and Other Security: Is Anything in Life Guaranteed?

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**Guaranties and Other Security: Is anything in life guaranteed?**

The following content will discuss lease credit benefits, shortcomings, negotiating tips, and methods to help you spot evolving issues in a post-Covid and modern retail world.

1. Lease Credit.

Lease credit (or security) is almost always required by landlords. Lease credit is essentially the mitigation of risk in the event of a tenant default. Landlords evaluate risk based on a variety of factors beyond the creditworthiness and financial strength of the potential tenant, such as: (i) site and market conditions (a new mixed-use center in a thriving suburban retail node vs. a class C strip on the outskirts of town); (ii) length and terms of the lease (e.g., substantial landlord's work or the provision of a significant tenant improvement allowance); (iii) competition in the market; and (iv) the negotiation preferences and skill of the parties (including lease credit consideration in initial discussions, promptly requesting and providing financial information and incorporating the lease credit concept into the initial letter of intent).

Additionally, there are a number of issues that must be considered when evaluating financial statements including: (i) whether they have they been prepared or audited by an independent accounting firm; (ii) whether they have been prepared in accordance with generally accepted accounting principles; (iii) the difference between net worth and tangible net worth; (iv) liquidity; (v) how assets are titled; and (vi) how marital property is treated by the courts in the applicable jurisdiction. For example, when should a spouse's assets be considered in the credit evaluation (and thus adding the spouse as a guarantor)? This analysis must include consideration of the Equal Credit Opportunity Act, 15 U.S.C. 1691 et seq. (e.g., if an individual guarantor has sufficient assets to provide lease credit under the landlord's prevailing review standards, would requiring the guarantor's spouse to sign a guaranty violate the ECOA?). In Hawkins v Community Bank of Raymore, the Supreme Court rejected the spousal guarantor's argument, but the court was divided and the opinion focused on what constitutes an "applicant". At a minimum, it is an issue/analysis that merits discussion.

2. Security Deposits.

The most basic form of lease credit is a cash security deposit that is tendered to a landlord at lease execution. In order to protect your client, consider whether the individual or entity providing the security deposit need to be named in the lease. There are pros and cons of a cash security deposit from each party's perspective. As a landlord, you hold the deposit and can co-mingle the deposit with your operating funds. Unlike residential security deposits, landlords often require that deposits not accrue interest, meaning those funds are working for the landlord (and, accordingly, not the tenant).

Unfortunately, a security deposit may not cover all damages in the event of a tenant default. Security deposits are considered part of a debtor's estate, and in the event of a bankruptcy are subject to the Bankruptcy Code's Section 502(b)(6) cap on rent damages. The 502(b)(6) cap is equal to the greater of one (1) year of rent or fifteen percent (15%) of the rent due and payable for the remaining lease term. Practically speaking, if the security deposit is less than one (1) year of rent, then it will be considered a secured obligation in the event of a tenant bankruptcy and will not be forfeited to the bankruptcy trustee.

For tenants, a security deposit may serve as liquidated damages in the event of any default. Many landlords are reticent to pursue litigation against a defaulting tenant given the potential of throwing good money after bad. This could be due to collection risks or even potential mitigation events. On the other hand, tenants typically must wait until the expiration of the term to recoup its deposit and it is difficult to get a deposit back in the event of disputes with landlords surrounding deductions. Tenants must also consider the very real risk associated with a bank foreclosure or landlord bankruptcy (which is especially poignant considering the likely impending deflation of commercial real estate assets as debt matures in the new post-Covid world).

3. Letters of Credit.

Letters of credit are instruments issued by third-party financial institutions that secure a tenant's obligations under the lease. In the event of a tenant default, a landlord can draw against the letter of credit (generally using an agreed upon method outlined in the letter of credit) with the bank issuing payment directly to the landlord. Letters of credit are typically collateralized by a tenant deposit at the bank. There are different types of letters of credit and each type provides a different level of protection. Specifically, (i) irrevocable (cannot be modified or canceled without agreement of the parties) vs. revocable (can be modified or cancelled by the bank at any time); (ii) standby (bank, as the obligor, pays landlord, as the obligee, up to a certain amount in the future in the event of a lease default); (iii) evergreen (contains an automatic annual renewal provision usually to an expiration date that

corresponds with the expiration of the lease); and (iv) transferable (the letter of credit can be reissued or transferred to a new owner).

Letters of credit provide benefits and risks to landlords and tenants alike. For landlords, a letter of credit typically can cover larger sums then cash security (given the various ways that tenants can collateralize the letter of credit). They also provide comfort in cross-border transactions (versus using a foreign based guarantor or a shell US subsidiary) or when trust and timing issues are exacerbated by causes beyond either party's control (such as political and supply/demand or infrastructure risks). Letters of credit do impose administrative burdens on landlords, such as tracking renewal/expiration or a bank's failure to renew a letter of credit for whatever reason. In addition, there have been innumerable instances where landlords have misplaced the original letter of credit, or it is lost in transmission, rendering its effectiveness moot, or at the very least challenging. While landlords generally negotiate transferability provisions into a letter of credit, on the practical side, in the event of sale of the property there can be administrative challenges in actually transferring the letter of credit. For a tenant, depending on the type of collateral pledged to the bank in consideration of the issuance of a letter of credit, it can free up cash that can be used for growth or other purposes. Given that a financial institution may accept collateral other than cash (e.g., working capital, personal mortgage), a letter of credit can be used to provide a landlord comfort where a tenant's financials may not otherwise meet lease credit criterion. A letter of credit also protects a tenant in the event of the landlord's mortgagee's foreclosure or landlord bankruptcy. The risk of a lost letter of credit not only presents risk to the landlord but the tenant as well. To illustrate, in one instance a lease expired and the tenant sought a return of its collateral from its bank. The bank required the original letter of credit in order to release the collateral. Unfortunately, the landlord purportedly lost the original. To secure the release of the collateral, the bank required that the beneficiary (landlord) tender an affidavit affirming that the original had been lost. In this instance the building had traded, and the original landlord was reticent to provide an affidavit (or cooperate in any way for that matter. The bank eventually agreed to accept an affidavit from the tenant, but not until months of negotiation and follow-up had passed.

There are numerous issues to consider when negotiating a letter of credit. Letters of credit usually are governed by either the Uniform Customs and Practice (UCP 600) or the International Standby Practice (ISP98). While comprehensive, the UCP presents certain problems for standby users (which is the nature of a letter of credit securing commercial leases), so the International Chamber of Commerce Banking Commission developed the ISP98 (adopted by the ICC in 1999), and is generally used by most practitioners. Another consideration is whether the landlord must present any evidence to the bank to authorize a draw. From a landlord's perspective, nothing more than a statement that it is entitled to draw and the amount of the draw should be provided. As a tenant, you would want notice and cure protection before any draw under the letter of credit. It is worth considering what happens or what you should do if the lease contains notice and cure, but the landlord draws under the letter of credit prior to the expiration of the cure period.

There are also specific terms in the letter of credit that must be addressed including: (i) the amount; (ii) the initial term, terms of auto-renewal and the final outside expiration date (which ideally would be 90 – 120 days after final expiration of the lease to account for damages that may accrue post expiration, such as the discovery that that the premises were not surrendered in the condition required by the terms and conditions of the lease – although this begs the question of what you do if the rent commencement date is indeterminable at the time of issuance); (iii) transferability (a landlord will want the ability to freely transfer the letter of credit to a buyer in connection with a property acquisition, and further that the cost of such transfer be borne by the tenant); (iv) notices to the landlord (whether by the tenant or financial institution); (v) conditions to draw; (vi) events of default; (vii) damage to property; and (viii) multiple and partial draws being permitted.

The recent collapse of Silicon Valley Bank, First Republic Bank and Signature Bank also highlight the critical importance of threshold rating requirements for the financial institution issuing the letter of credit, and the process that a tenant must go through should its financial institution come under regulatory scrutiny, a run on cash or a precipitous drop in market capitalization. Would this constitute an event that would entitle the landlord to draw under the letter of credit (further exacerbating the run)? Note that having the tenant find a different bank to issue a new letter of credit is not an insignificant undertaking depending on how much of the tenant's assets are deposited in the at-risk institution. While SVB, First Republic and Signature were effectively bailed out, it remains an open question as to whether those successors would have been legally obligated to honor outstanding letters of credit.

Finally, the timing of the actual issuance of a letter of credit is important. Ideally, a landlord will want to have the original letter of credit in hand at lease execution. However, in our experience there is often a push to get a lease signed before the tenant completes all of the red tape associated with having a letter of credit issued to a landlord (with this pressure often coming from a landlord's own representatives notwithstanding the risk). The danger is that if a landlord is relying on a letter of credit to secure a tenant's obligations, what happens if the letter of credit is not issued for any reason? Of course, the landlord could hold the tenant in default and seek to have the

lease terminated, but this will take time and money, often without recourse to the tenant given that the lease security was the letter of credit.

4. Guaranty.

A lease guaranty is a separate contractual agreement between the landlord and a third party whereby the third party guarantees certain obligations under a lease. The term "guaranty" can only be used as a noun, whereas the term "guarantee" can be used as both a noun and a verb. "Guaranties" is the plural of guaranty. In other words, someone guarantees obligations via a guaranty or multiple guaranties. Guaranties can be provided by individuals or entities (or both). Personal guaranties are generally provided by principals of the tenant who have a net worth that is substantial enough to serve as lease credit. Entity guaranties are provided by parent or affiliated companies, again with financial statements that support lease credit. Care must be used in analyzing financial statements to ensure that there are truly assets available to secure the tenant's obligations. By way of example, consideration of a spousal guarantee or whether the entity providing the guaranty is truly the "money entity" in the chain of ownership. Liability under guaranties should always be joint and several.

As with the other forms of lease credit, there are risks and benefits associated with using a guaranty. Guaranties allow landlords to access additional sources of funds which may be more liquid, diverse or proven than that of the tenant itself. The phrase "having skin in the game" also comes to mind. A landlord must be thoughtful in following the correct protocols for preserving, triggering and enforcing a guaranty including notice and cure and modifications and enhancements. Of course, there is also the issue of collection, and pursuing the guarantor in litigation outside of the realm of the relatively friendly landlord/tenant court. A landlord must also be mindful of common law defenses to a guaranty including novation, or substitution of a new contract for the one that was in place, which may extinguish original guaranty. For example, the original tenant is sold to new tenant, which assumes original tenant's obligations as tenant under the lease. Landlord and new tenant are not subject to a formal assignment agreement or consent, but both parties continue performing under the lease. New tenant defaults on its obligations under the lease and landlord seeks to hold the owner of original tenant (who personally guaranteed the lease) liable for damages under the lease. Without addressing this issue in assignment/consent or the guaranty, because the owner of the original tenant only personally guaranteed the obligations of the original tenant, and not the new tenant, he/she may not be responsible for the damages accruing under the lease. There is also the doctrine of strict construction (a guaranty of another individual's compliance with his or her contractual obligations is generally interpreted strictly against the beneficiary of the guaranty).

A sophisticated landlord will also ensure that a guaranty is a separate and distinct instrument, even if attached to the lease as an exhibit. This will avoid a guarantor's argument that the guaranty terminates on lease termination. For tenants, guaranties provide an obvious benefit – they can be used in lieu of cash that would otherwise be tied up in a security deposit or collateralized in a letter of credit.

Interestingly, many practitioners only lightly negotiate landlord form guaranties, but in reality there are many issues to be considered. Key issues include: (i) being continuing and non-revocable; (ii) a guarantee of performance versus a guarantee of payment (can performance truly be guaranteed?); (iii) waiver of guarantor's defenses; (iv) no obligation to first pursue tenant; (v) novation (modification of the lease) including renewals and expansions; (vi) any obligation to make demand of the guarantor; (vii) addressing strict construction; and (viii) providing for substitute guarantors. Particularly aggressive landlords include confession of judgment clauses within guaranties (which allow a landlord to have a judgment entered against a tenant without benefit of a hearing). While commonplace in Pennsylvania there are a myriad of reasons why tenants should avoid them including the inability of the tenant to present a defense at a hearing. One of the more interesting issues that is often unaddressed in a guaranty (or a lease for that matter) is the effective assignment of the guaranty by the guarantor. If the guarantor is subject to an acquisition or merger, you should evaluate whether that constitutes a default under the guaranty or perhaps an assignment under the lease.

Often, the biggest point of negotiation among parties in connection with a guaranty is a cap or other limitation on the damages that are collectible under a guaranty. As a tenant, the concept of a guaranty cap should be introduced very early into the lease negotiation process, and should be clearly addressed in the letter of intent (since in our experience it is difficult – although not impossible – to introduce the concept into lease negotiation). Caps come in many forms., These include: (i) limits on monetary scope (whether static at a specific Dollar amount or rolling; e.g., twelve (12) months of the then current base rent, passthroughs and percentage rent based on a pre-determined time period); (ii) duration (e.g., the guaranty terminates after the expiration of the fifth (5$^{th}$) Lease Year; guaranty is only effective during the initial term); and (iii) reductions over time (e.g., one-third at the expiration of the third (3$^{rd}$) Lease Year and an additional one-third (1/3) at the expiration of the sixth (6$^{th}$) Lease Year). Well written guaranties (at least if you are a landlord) will also include a "good guy" component (as discussed below), attorneys' fees for collection and potentially the cost of returning the premises to the condition required by the terms of the

lease. If a cap is used, a landlord should make sure that all expenses (not just rent) are taken into account (e.g., rent concessions, brokerage commissions, tenant improvement allowances and other landlord investments amortized during the term). A guaranty should also apply to all additional rent obligations under the lease, such as indemnification damages. Many guaranties fail to use a "guaranteed obligation" definition to include the foregoing and only address the base rent and passthroughs payable under the lease. In addition, landlords should push for any termination or reduction of a cap being conditioned on the tenant not being in default, or even not having been previously in default at any time prior to the termination/reduction.

No discussion of lease guaranties would be complete without an analysis of the so-called good guy guaranty. This type of guaranty originated in New York given the challenge of obtaining an actual eviction. Landlords were in the position where a tenant would default under its lease and continue operating without paying rent for months or years given the quagmire of the court's docket and length of time that it takes to effectuate an eviction. While good guy guaranties originated in New York, they are now widely used, especially in light of Covid and eviction moratoria. At its essence, a good guy guaranty limits the guarantor's exposure from the period of default until the time that the premises are surrendered in the condition required by the terms of the lease. As discussed above, while good guy guaranties are used outside of New York, they are often included within a guaranty cap concept. Note that the analysis of good guy guaranties does not end with the mere inclusion of the concept, because clever attorneys have added conditions to the effectiveness of the release of liability that occurs upon surrender. By way of example, a condition could be providing the landlord advance written notice of a default (effectively lengthening the period of the guaranty) or providing certification from the tenant that a partner/guarantor has withdrawn from the partnership (see 150 Broadway v. Shandell). If the conditions to the good guy guaranty are not satisfied, a guarantor may be liable for ALL future rent notwithstanding the surrender of the premises (see Broadway 36th Realty, LLC v. London).

5. From Covid pandemic to Covid endemic.

As a result of the Covid pandemic, a number of unique issues evolved - from high tenant defaults to eviction moratoria. For example, if a jurisdiction instituted a moratorium on evictions, would it effectively ban enforcement under a guaranty?

Not only were eviction moratoria introduced, but New York City went so far as to pass N.Y.C. Local law No. 55 of 2020 (the "Guaranty Law"), which relieved individuals and personal guarantors of liability for periods between March 7, 2020 to June 30, 2021. The Guaranty Law was struck down in April in the case Melendez v. City of New York for being violative of Article 1, Section 10 of the United States Constitution (the Contracts Clause). However, just one month later (May 2023), a New York Supreme Court for New York County in Mansion Realty, LLC c. 656 6th Ave Gym, LLC, held that the law was enforceable (but only excused payment for the period that the law covered, not for any time thereafter). Note that the New York Supreme Court is not bound by a lower Federal Court decision (although it would be subject to any Supreme Court decision).