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Cash or Credit...Landlords Beware!

by Jordan N. Uditsky

Introduction

Though it may seem that the economy is on the mend, a quick discussion with the leaders of many area businesses exposes an underlying unease as to whether the economy as a whole can sustain its recovery given the inability of bureaucrats in Washington to craft long-term solutions to our country's financial crisis. Many of these businesses continue to struggle to remain profitable and avoid the financial pitfalls of the recent recession. These same struggles affect more than the businesses themselves, and when a business' financial struggles involve a bankruptcy they can have devastating results for creditors, particularly commercial landlords. While commercial landlords either holding a cash security deposit or a letter of credit may think themselves isolated from a tenant's bankruptcy, some have found that neither is actually immune from risk.

Cash Pitfalls

Cash security deposits have long been the traditional form of security for a commercial lease, typically in the amount of one to two month's rent. However, the recent financial crisis exposed a weakness in what was otherwise thought to be ironclad security against a tenant's default. When a tenant declares bankruptcy the landlord may find themselves enmeshed in a fight with the bankruptcy trustee to retain that security deposit. A cash security deposit is generally regarded as an asset of the bankruptcy estate under Section 541(a). Courts have held, however, that landlords may offset a portion of the security deposit against their allowable claims but that any surplus must be returned to the debtor (Oldden v. Tonto Realty Corp., 143 F.2d 916 (2nd Cir. 1944)). They have gone further to provide that a landlord's security deposit constitutes a perfected security interest or lien in the landlord's favor (In re Johnson, 215 B.R. 381, 384 (Bankr. N.D. Ill. 1997)). It would seem the landlord's ability to retain the security deposit is an equitable remedy until one examines and understands what an "allowable claim" is under the Bankruptcy Code.

A debtor-tenant has the ability to reject certain leases pursuant to Section 365 of the Bankruptcy Code. Such a lease rejection is tantamount to a default under the terms of most leases giving the landlord a general unsecured claim against the bankruptcy estate for the resulting damages. Unfortunately, the landlord's claim is limited by Section 502(b)(6) of the Bankruptcy Code to the amount of accrued but unpaid rent plus the amount of rent reserved under the lease for the greater of one year or 15% of the remaining term of the lease. To the extent the cash security deposit exceeds the amount of the Landlord's claim, it must be returned to the debtor's bankruptcy estate.

Cash or Credit...Landlords Beware! – continued

Why is a Letter of Credit Better Than Cash

In order to provide some insulation from the risk of a security deposit being tied up in a tenant's bankruptcy, many landlords prefer the issuance of a standby letter of credit. A standby letter of credit issued by the tenant's bank or, preferably, a bank satisfactory to the landlord is an independent obligation of the issuing bank to the landlord. The letter of credit stands apart from the tenant's obligation to reimburse the issuing bank and is therefore not generally a part of the bankruptcy estate. Less risk? It would seem that way until one considers the long list of bank failures over the past several years and the FDIC's unwillingness to honor letters of credit issued to commercial landlords by failed banking institutions. With the economic recovery still uncertain, commercial landlords should take proactive measures in their leases requiring tenants to replace letters of credit issued by insolvent banks and permitting the landlord to make a periodic review of the letter of credit issuer. Landlords should also reserve the absolute right to approve the bank issuing the letter of credit or provide a list of acceptable financial institutions from whom they will accept a letter of credit. It should also be noted that the interaction between a landlord's proposed draw on a letter of credit and the 502(b)(6) cap is unsettled. Landlord's should anticipate that any drawdown on a letter of credit may have an impact on the amount of the landlord's claim in a tenant's bankruptcy.

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