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Cash is king...or not? Landlords and tenants should consider the specifics of a lease transaction

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Landlords and tenants rarely pass the letter of intent stage in any commercial lease negotiation without a thorough discussion about security for tenants' obligations under a lease. While landlords may be quick to demand cash security deposits from commercial tenants - the more cash the better - that conclusion may not always be in a landlord's best interest. Stand-by letters of credit provide a useful alternative under the right circumstances. Likewise, tenants should consider expanding negotiations to include discussion about letters of credit for their own reasons as well. As more leases provide for letters of credit as security, the law in this area continues to develop and additional factors must be considered.

A landlord's primary motivation in seeking security under a lease agreement is to ensure payment in the event its tenant becomes insolvent. A default in tenant's obligations could impact the landlord's ability to meet its own obligations under a mortgage or otherwise. Unfortunately, insolvency laws, including bankruptcy, change the rules of the game and may delay, limit or altogether prohibit a landlord from actually taking cash held as a security deposit in satisfaction of a tenant's debt. The problem lies in the fact that a security deposit remains property of the tenant despite the fact it is paid over to and held by the landlord. As tenant's property, the security deposit is part of the bankruptcy estate and therefore subject to the automatic stay triggered by a tenant's bankruptcy. Without relief from the bankruptcy court, the landlord cannot use the tenant's funds. Even if the landlord has a perfected priority security interest in the tenant's security deposit, by virtue of its possession of the funds or otherwise, taking such funds without court approval could be deemed a violation of the automatic stay and subject the landlord to penalties. Furthermore, to the extent the landlord applied its tenant's security deposit prior to the tenant's bankruptcy, any funds collected in the ninety days prior to the bankruptcy filing could be recouped by a debtor in possession or bankruptcy trustee as preferential transfers.

Alternatively, if the landlord had obtained a letter of credit in support of tenant's obligations under a lease, the landlord could present the letter of credit directly to the issuing bank, which would obligate the bank to pay the landlord's claim pursuant to the terms of the letter of credit. In general, amounts received by the landlord directly from the issuing bank are treated like payments received from a guarantor and may not be subject to any preferential transfer action or otherwise require a bankruptcy court's permission before receipt. Some courts are hesitant to allow this result where language in the lease requiring the letter of credit is not properly drafted or where the letter of credit is secured by tenant's cash. For instance, where a lease provides for the option to use either a letter of credit or security deposit, a bankruptcy court may find that the letter of credit is analogous to a security deposit and will treat it as such. Also, where a letter of credit is secured by a debtor's underlying cash collateral, a court may treat the letter of credit as cash and impose limitations such

as those found under Section 502(b)(6) of the Bankruptcy Code. The First Circuit has not conclusively ruled on these issues yet, while other circuits have offered conflicting guidance; however, careful drafting of both the lease and letter of credit may increase the likelihood that a landlord may freely exercise its rights in the event of tenant's bankruptcy.

Tenants may also see the benefit of a letter of credit where a landlord becomes insolvent and converts a tenant's security deposit for its own use in the absence of a default. Commercial landlords are generally allowed to comingle tenants' security deposits with their own funds. At any given time, tenant's security deposit could be subject to creditor attachment or a bank's perfected security interest, to the extent that the deposit is in landlord's general accounts. If the landlord's depository bank is also a secured creditor, the bank could simply reach into the landlord's operating account and take the funds without notice or demand to the tenant. Moreover, if the landlord files for bankruptcy protection, a tenant's claim for return of its security deposit would stand in line with other general unsecured creditors, absent expensive legal wrangling to prove a constructive trust or other priority claim to the funds. It may be possible to address some of these issues in a negotiated subordination, non-disturbance and attornment agreement between the tenant, the landlord and its bank, but a tenant could avoid landlord insolvency issues through use of a letter of credit. So long as the tenant is not in default under the lease, a properly drafted letter of credit should be outside the scope of any claims or liens asserted by landlord's creditors.

The drafting and negotiation of a letter of credit adds transaction time and cost at the inception of a lease, but these costs may be offset by mitigating risk on both sides of the equation. A letter of credit may also cause a tenant to incur finance fees and interest expenses, but such costs are a function of the bank and the availability under any existing credit facility held by a tenant. An ancillary benefit to the landlord derived from discussing the possibility of a letter of intent is insight into the tenant's creditworthiness, that may or may not be apparent from financials and other disclosures obtained in the course of lease negotiations and due diligence. At the very least, both parties should consider the specifics of any particular lease transaction before settling on a cash security deposit over a letter of credit from a healthy bank.

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