Mitigating lease risk: Key tools for landlords with smaller tenants - by Daniel Meyer

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While not all landlords prefer – or are able – to lease their commercial properties exclusively to large, creditworthy "national" tenants, these tenants are attractive due to their strong financial stability. However, what about the small businesses and middle market companies that make up a significant share of office, retail, and industrial leases? Are there ways commercial landlords can mitigate some of the credit risk that accompanies leasing to smaller tenants?

Yes, there are certain credit enhancement techniques employed by commercial landlords during the Letter of Intent and lease negotiation process that help limit such default and payment risk (though certainly not eliminate it entirely).

This DE Insight will provide a quick overview of two of the more common credit enhancements employed by commercial landlords – security deposits and guaranties. Other standard credit enhancements not discussed in this article include, without limitation, the use of (i) letters of credit (commercial and standby) and other certifications from financial institutions; (ii) payment and performance bonds (particularly in the retail space); (iii) pledges of alternative collateral from the tenant and its principals and/or affiliate guarantors; and (iv) the statutory landlord's lien.

Please note that the techniques included below are not easily employed with smaller tenants, given those tenants' more limited cash reserves and, in some cases, limited operating history. I'd also note that my use of "smaller" when describing certain tenants is more a reference to their credit profiles than footprint or head count. Finally, entire articles can be written on each credit enhancement technique, as well as their interplay with the tenant's own financing needs, subordination, non-disturbance, and attornment agreements and related matters, and other areas of the law that intersect with credit enhancement, so please excuse my brief descriptions above.

Security Deposits: The use of cash security deposits is standard in all leases, whether residential or commercial. The obvious attraction for landlords is that, subject to applicable laws governing security deposits in each state, which are often focused more on residential leasing, the cash security deposit is liquid and can generally be accessed by the landlord without the need to resort to drawn out court proceedings. The larger the security deposit, the greater the credit enhancement, with smaller deposits being useful for small fixes under the lease but not sufficient to buttress the performance of a smaller tenant.

Another advantage to a larger cash security deposit is that, unlike with personal or corporate guaranties, a security deposit's value remains largely consistent across the term of the lease, with the only fluctuations being that of the changes in the inflationary and larger economic landscape throughout the lease term. The main drawbacks include: (i) smaller tenants' inability/unwillingness to post larger cash deposits; and (ii) that the cash security deposit is deemed part of the tenant/debtor's bankruptcy estate should the tenant file.

One potential compromise employed by landlords for big security deposit asks (and for guaranties) is to provide for a "burn-off" of the deposit over the term of the lease (or upon the reaching of certain lease milestones, such as completion of tenant buildout improvements), such that the tenant's cash is not tied up for the entire term. Liability caps and burn-off arrangements are widely negotiated by commercial landlords and tenants, and such arrangements can generally be tailored in a way that limits the landlord's downside risk of tenant default and nonpayment while also freeing up the tenant's (or guarantor's) cash to deploy elsewhere.

Personal and Corporate Guaranties: Another widely used credit enhancement is the use of personal or corporate guaranties from a tenant's principal(s) and/or parent and/or affiliate to backstop the tenant's obligations under the lease. There are many aspects of guaranties in leasing – e.g., payment versus performance, spousal co-guaranties, limits and burn-off, continuation post-assignment or subletting, joint and several liability, etc. – that we will address in future articles.

The main attraction of guaranties is that they are often unlimited (unless a cap or burn-off is negotiated), with the guarantor(s) guaranteeing the full performance of all of tenant's obligations under the lease. The primary downsides to using guaranties include: (i) they typically require landlords to sue to enforce and are not quickly converted to cash; (ii) the underlying guarantor's own credit profile, whether personal or corporate, may change for the worse over the term of the lease; and (iii) there is some confusion among the bankruptcy courts about whether guaranties are subject to the automatic stay in the tenant's bankruptcy proceedings, with some courts using their equitable powers to make guaranties subject to the stay to protect the reorganization efforts of the debtor tenant. Guarantors are also permitted to assert any tenant defenses under the lease against the landlord in any legal proceeding to enforce the guaranty, another drawback to their use.

Conclusion: The above credit enhancements should be the first stop for any commercial landlord when negotiating with smaller tenants. The other techniques mentioned briefly will often only come into play in specific circumstances with specific types of tenants. The statutory landlord's lien varies from state to state and will still require court proceedings to enforce, bonds are often cost-prohibitive for smaller tenants, and letters of credit are often only available (or useful) to more established tenants and their principals and other backers.

By thoughtfully incorporating credit enhancement strategies into lease negotiations, landlords can better protect their investments. As landlords and tenants structure your next deals, be sure to consult with experienced counsel to tailor the right protections for your situation.

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