SHELL GAMES TENANTS PLAY: GUARANTIES, LETTERS OF CREDIT AND SPECIAL PURPOSE ENTITIES.

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1. Introduction

Smaller and larger, unsophisticated landlords commonly become excited when they procure a seemingly creditworthy tenant to anchor a new development or to provide the financial basis for the construction of a large, single-purpose building. Visions of steady rental income arriving on a regular monthly basis start dancing in the landlords' heads. Many of these unsophisticated landlords, however, fail to see beyond the sleek corporate jet, the strong balance sheet of the large corporation that is theoretically offering to rent their property, and the prospect of a continuous stream of rental payments far into the future.

Unfortunately, the decision to rent to a tenant is a credit decision. Appearances can be, and often are, deceiving. Landlords need to look behind the glitz of the jets and the façade of the balance sheets. Landlords must know their prospective tenant's precise identity before making the substantial financial commitments often required by these long terms leases.

Landlords often seek to avoid these potential pitfalls by obtaining security for leases, in the form of deposits, leasehold guaranties, or letters of credit.[1] However, a security deposit may not be available.[2] Obtaining an adequate cash security deposit to secure the financial commitment required by these leases is generally not available.[3] Landlords who rely on cash security deposits to secure their tenants' obligations still face risks in the event of a tenant bankruptcy, such as having to address the provisions of the automatic stay before obtaining this security deposit.[4] If a landlord opts to obtain security in the form of a guaranty, the landlord must know the precise

[1] *See generally, Security Deposits v. Letters of Credit*, REAL ESTATE, LAND USE, AND ENVIRONMENTAL NEWSLETTER (Choate Hall & Stewart, LLP) (March 2003) *available at* http://www.choate.com/file/pdf/publications/re_march_03.pdf [hereinafter *Security Deposits v. Letters of Credit*]; Barbara M. Yadley, *Letters of Credit and Leases*, 7 PROPERTY WRITES, No. 2 at 9 (2003) (Holland & Knight, LLP) *available at http://www.hklaw.com/Publications/Newsletters.asp?IssueID=372&Article=2081*[hereinafter *Yadley*]; Susan Fowler McNally, Carter Klein, and Michael Abrams, *Letters of Credit in Lease Transactions, Part I: Advantages to Landlord and Landlord's Lender*, 16 PROBATE & PROPERTY No. 4 (July/Aug.2002) [hereinafter *Letters of Credit*].

[2] *See generally Security Deposits v. Letters of Credit, supra* note 1.

[3] *Id.*

[4] *Letters of Credit, supra* note 1.

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identity and financial wherewithal of the guarantor as well as the tenant. The landlord must carefully analyze the basis for the alleged financial strength on the balance sheet of the tenant as well as any proffered guarantor.

Many landlords think that the solution to the problem of security for a lease is a letter of credit.[5] After obtaining a letter of credit to protect against the tenant's default, landlords often believe that the credit risk associated with a default has been shifted to the issuer of the letter of credit.[6] However, letters of credit are not the panacea thought by some, because letters of credit have their own risks.[7]

This paper examines some of the "shell games" increasingly played by tenants to avoid liability under a lease.[8] Given the myriad of shells that can be moved, a landlord cannot protect against every eventuality. Before a landlord expends considerable sums of money on tenant upfit or building a special-purpose building for which a broad market does not exist, the well-advised landlord will carefully consider these shell games in order to reduce the risk of being caught short if the tenant defaults.

Long-term leases pose particularly difficult problems. While it is virtually impossible for the landlord to protect itself against every possible, long-term scenario, the landlord should pay particularly close attention to certain areas, including:

i. Proper analysis of a tenant's balance sheet;[9]

ii. Analysis of the validity of the tenant's ostensible need to have single-purpose entities or subsidiaries act as the tenant or guarantor of a lease;

iii. Analysis of whether the tenant has properly authorized the execution of any lease;

iv. Consideration of often overlooked lease provisions, such as notice provisions and provisions regarding assignments to affiliates or a transfer arising from a change in ownership control. For example, many landlords do not pay particular attention to the definition of an "affiliate" when negotiating a lease;

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[5] *See generally* David R. Kuney, BANKRUPTCY ISSUES FOR COMMERCIAL LANDLORDS, TENANTS AND MORTGAGEES 67-76 (2006) [hereinafter *Kuney*].

[6] *See Yadley, supra* note 1, at 9.

[7] *See* Suzanne M. Amaducci, *Letters of Credit Help Protect Landlords Against Tenant Bankruptcy*, 22 COMMERCIAL INVESTMENT REAL ESTATE No. 2 at 16-17 (March/April 2003) *available at http://www.bilzin.com/news/lettersofcredit.php* [hereinafter *Amaducci*]; *Security Deposits v. Letters of Credit, supra* note 1.

[8] Not all of these tenants are large corporations.

[9] Andrew H. Mittler, *Guarding Against Tenant Bankruptcy: These Strategies Can Held Landlords Protect Their Interests When Tenants File*, COMMERCIAL REAL INVESTMENT REAL ESTATE (Jul/Aug. 2002) *available at* http://www.ciremagazine.com/article.php?article_id=257 [hereinafter *Mittler*].

v. Determination of the appropriate security.

Most landlords and their lenders determine the amount of a loan by considering the capitalized net rental income payable under a lease. That rental income is the obvious primary source of funds to service the debt. At its most basic, the decision to lease to a tenant is a credit decision. The tenant has sufficient financial wherewithal to ensure the cash flow of rent during the term of the lease. If the tenant does not have sufficient, tangible assets to justify the credit decision, then the prudent landlord should consider the certainty of the income stream being used to justify the decision to lease.

Leases are sometimes more than a credit decision. Many tenants bring more than just the stream of rental income to a project. For example, an anchor tenant often brings synergy to a shopping center or to an office project, making the overall project far more attractive to the landlord. A good example is the landlord's decision to construct a single-purpose entertainment venue, such as a theater. The theater brings far more to the project than the income stream generated by its lease. If the tenant were to shut down operations or change operations in a meaningful way, the vitality of nearby restaurants or retail locations could be threatened. Anchor tenants in regional malls are another example.

Landlords must carefully negotiate assignment provisions and "go-dark" provisions for these tenants. While few landlords consider the significance of the assignment language when negotiating the original lease, landlords should consider the possibility that the tenant's fundamental operations may change. A tenant who provides high energy, Broadway-type shows five (5) nights per week during forty (40) weeks of the year differs substantially from a tenant who puts a beer-guzzling banjo player on a stool in front of an audience. If the go-dark provision simply establishes that the tenant will continue to provide entertainment similar to that provided in the tenant's other venues, the landlord who anticipated the Broadway show could find himself with the banjo player if the tenant sells its interest in other venues or changes or ceases operations at other venues.

Similarly, the assignment provisions of a lease must be carefully crafted. A provision permitting assignment by the tenant to other "affiliates" is woefully inadequate when the term "affiliates" is not well-defined.

Long-term leases pose particularly thorny problems. For example, a tenant will almost never have the ability to post a deposit that is sufficient to address the real economic risk to the landlord created by a default on a long-term lease. Bankruptcy, with the damage cap imposed by Bankruptcy Code,[10] also poses a significantly greater risk to landlords under long-term leases. Finally, the tenant with a successful business model in the current economic environment may not have a model that will succeed in a different economic environment in five or ten years.

[10] Damages cannot severally exceed the greater of one year's rent on fifteen percent (15%) of the remaining term, not to exceed one year. *See* 11 U.S.C.A. § 502(b)(6) (2000 & Supp. 2006). For a more complete discussion, *see* text accompanying notes 65-68, *infra*.

2. Balance sheet analysis

Prudent landlords carefully scrutinize the balance sheet of a tenant or a guarantor before undertaking the landlord's obligations of a lease.[11] While one would think it almost inconceivable that even a modestly sophisticated landlord will not closely examine a prospective tenant's balance sheet before entering into a lease, it does happen. More frequently, the landlord fails to analyze the tenant's balance sheet sufficiently to understand key strengths and, more importantly, weaknesses.

An analysis of a tenant's balance sheet requires more than a cursory examination of the tenant's net worth. It is increasingly rare that a smaller tenant, and even many larger tenants, will have sufficient, tangible net worth that provides an adequate remedy in the event of default.

Moreover, few landlords have the ability or the perspicacity to maintain a vigilant watch over tenants whose financial condition changes, some caused by changes in a tenant's financial condition and others by transferring tangible assets to an affiliate. In an era where net worth often dependant upon to the value of a tenant's intellectual property, how much value should a sophisticated landlord attribute to items like goodwill on a balance sheet? For example, the vast majority of an entertainment company's net worth generally is shown on the balance sheet as goodwill.[12] With so much of a company's net worth being in the form of "non-tangible" sources, such as goodwill, a prudent landlord must determine whether the tenant really can support a long-term lease.

It is axiomatic that a landlord should begin to consider the prospects of a tenant default when negotiating a lease, not after the landlord discovers that the tenant faces financial difficulty. Providing for security in the form of deposits, lease guaranties, and letters of credit obviously warrants a landlord's close scrutiny. Four additional critical provisions in leases include:

i. Assuring that the lease has been properly authorized by appropriate company authority;

ii. Financial reporting by the tenants;[13]

iii. Assignment restrictions in the lease; and

iv. Notice provisions

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[11] *Mittler, supra* note 8.

[12] *See, e.g.*, Financial statements as of January 3, 2007 from Gaylord Entertainment Company and Regal Entertainment Group indicating goodwill estimates as $173,320,000 and $224,100,000, respectively *available at* http://finance.google.com/finance?fstype=bi&cid=655923 and http://finance.google.com/finance?fstype=bi&cid=672656 (last visited Jan. 4, 2007).

[13] *Mittler, supra* note 8.

It is not uncommon for a landlord to ignore, when preparing the lease, the importance of how notice is to be provided to both defaulting tenants and to lease guarantors. Telecopied and e-mailed notices are particularly problematic. Leases often do not provide a satisfactory method for changing the location to which notice is to be delivered upon the occurrence of an event of default. When it "counts" during the term of a lease, a landlord must ensure that proper notice is given both timely and to the correct location, to minimize defenses that otherwise might be available to the tenant or the guarantor.

While many are familiar with the New York Stock Exchange's "Know Your Customer" Rule,[14] many landlords do not take comparable care in knowing their tenants or lease guarantors. As previously noted, the landlord must examine the tenant's balance sheet closely and consider whether to impose financial reporting requirements.[15]

Another area of concern is determining when the lease term (not the effectiveness of the lease agreement document, which is on signing) commences. Many leases provide that the leasehold term commences upon completion of construction of tenant improvements. At that point, the lease may require that the tenant deliver a letter of credit. Many leases, however, do not clearly enough define completion of construction or the outside date for completion of construction.

Landlord's build-out and tenant improvements are typically made at the commencement of a lease to accommodate a tenant's intended use of the leased premises. Obviously, improvements can be made by the landlord, by the tenant, or by both. If the lease has not specifically detailed the responsibility for the buildout and the nature of the improvements, then tenants or lease guarantors can use a landlord's failure to complete the buildout in accordance with the specific terms of the lease as a means to escape liability. Avoiding this pitfall requires a landlord to address several things, including:

i. Specifying the time period required to complete any improvements;

ii. Detailing the responsibilities between the landlord and the tenant for the design of the improvements;

iii. Specifying who pays for the work;

iv. Providing a specific tenant remedy if landlord is late in completing its work;

v. Providing a mechanism for handling change orders and mechanics liens;

[14] New York Stock Exchange Rule 405 provides "[e]very member organization is required . . . to (1) [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."

[15] *Mittler, supra* note 8.