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MITIGATING SELECTED RISKS OF INSOLVENCY: SECURITY DEPOSITS, LETTERS OF CREDIT, TENANT IMPROVEMENT FUNDING, AND SNDAS

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I. MITIGATING SELECTED RISKS OF INSOLVENCY: TENANT SECURITY DEPOSITS, LETTERS OF CREDIT, TENANT IMPROVEMENT FUNDING, AND SNDAS

A. **Overview**. This outline attempts to identify recurring issues that arise from the insolvency of a landlord or tenant or the failure of either party's lender. Some consider the risk of a bank failure too remote to worry about and the costs of tweaking documents to address those risks too high to bother with. Perhaps they are right. But a bunch of California, Boston, and New York lawyers at an ACREL meeting last March who spent the previous week taking frantic calls from anxious clients after the FDIC shuttered Silicon Valley Bank and Signature Bank might beg to differ. Their clients were asking how these unexpected bank failures would affect outstanding letters of credit, security deposits, operating accounts, and the like.

B. **Topics and Approach**. The topics in this outline are few, and the approach to them is simple. There are four relatively discreet topics: One, tenant security deposits. Two, letters of credit. Three, funding and performing tenant improvements; and four, SNDAs, which routinely address the other three. The outline focuses on the competing rights and interests of the parties when a landlord or tenant faces insolvency or one party's lender fails. To this end, the outline: reviews typical lease terms pertinent to each topic, including some terms that might be overlooked; considers what the law says on each topic when the lease says nothing or something else; considers common loan terms that affect the rights and obligations of the landlord and tenant to each other and their practical ability to perform their respective obligations or to get the benefit of their bargain; and assesses the foreseeable impacts of insolvency of the landlord or the tenant or the failure of either party's lender.

1. ***Security Deposits***. Tenants post them. Landlords deposit them, often in unsegregated accounts intermingled with the landlord's own operating funds. When a landlord gets a mortgage, the landlord-borrower also typically grants a lien in its deposit accounts. The landlord's lender sometimes requires the landlord to enter into a deposit account control agreement (DACA) to perfect then lien on the cash in such accounts and to give the lender control over the income stream from the property. One problem is that, absent a tenant default, the landlord is pledging only "its rights in" tenant's cash security deposit subject to the terms of lease conditioning the landlord's right to and use of such funds. The gist of most loan documents is that the borrower-landlord grants the lender a lien in the borrower-landlord's "rights in the leases and tenant security deposits." Having the tenant's funds applied to the landlord's debt to is lender is not one of the permitted purposes in the lease. What could go wrong?

a. *Landlord's Lender Fails*. Say the landlord deposits the tenant security deposits in an unsegregated deposit account and the funds become untraceable under the methods typically used to trace funds in intermingled accounts. The balance of the deposit account exceeds the standard insurance amount of $250,000. The landlord's bank fails. The landlord is still alive, and it still has a statutory and contractual obligation to refund the tenant's security deposit. But when the time comes, it must replace the uninsured portion of any tenant security deposits with its own funds. Likewise, the landlord still has a now illusory right to apply the tenant's security deposit if the tenant defaults. There has got to be a better way. The borrower-landlord could have better protected itself and its tenants by depositing each tenant's cash security deposit into a segregated account for all tenant security deposits and recording the balance of each deposit in the deposit account records at the bank. The outline cites the authorities that would allow a landlord to take advantage of the deposit insurance limits available to each tenant if the landlord is willing to follow the existing rules. The Texas Property Code already requires a landlord do the hard part: keep accurate records of tenant security deposits. Why not keep those records as part of the deposit account records at the bank?

b. *Landlord Defaults on its Mortgage*. This scenario usually ends badly for everyone involved. Landlord deposits tenant security deposits in an unsegregated account. Landlord then defaults on its mortgage. Landlord's lender sweeps landlord's unsegregated deposit accounts, which intermingle landlord's operating funds with tenant cash security deposits. When one tenant's lease expires, that tenant, who fully performed its lease, demands that landlord return the security deposit.

Under the lease, tenant is entitled to it, and, in the absence of a tenant default, landlord, and thus landlord's lender, might has no interest in any swept funds that are traceable to tenant's security deposit. Under what circumstances might the lender be held liable to the tenant for conversion? What does a typical lease and SNDA have to say on the topic?

c. *Tenant files Bankruptcy*. Is a security deposit property of the bankrupt tenant's bankruptcy estate? What kind of claim, or claims, does the landlord have against the tenant-debtor's bankruptcy estate if the tenant rejects its lease? Can the landlord apply the tenant's security deposit? Does the automatic stay, until lifted by court order, bar the landlord from doing so? What happens if the tenant rejects its lease?

2. **Letters of Credit**. Letters of credit are sometimes offered to a landlord in-lieu of a security deposit. Sometimes the landlord prefers a letter of credit. And other times the tenant prefers to pay the fees and to pledge collateral, on which it gets some return, to support a letter of credit rather than to leave a sizeable cash security deposit in a non-interest-bearing account for the duration of a lease with a term of ten years of more. In some lease transactions, desirable tenants are now negotiating security enhancements from landlords to secure the landlord's performance of certain lease concessions, such as large tenant improvement allowances, commissions, and the like. Letters of Credit are one way to secure performance parts of such a concession package. Mortgage lenders and leveraged property owners might need to reassess and address this market development in their loan underwiring and documentation so that their borrowers can compete for such desirable tenants with low debt or debt free project owners. This outline discusses the issues raised by the insolvency of the issuing financial institution, the beneficiary, and the applicant in connection with lease related letters of credit.

3. **TI Construction and TI Allowances**. Negotiating SNDAs work letters that address these issues ranges from challenging to nightmarish. Each party to the negotiation has legitimate and conflicting interests on difficult issues. One sometimes unavoidable problem is that all of the affected parties are not at the same bargaining table at the same time. Tenants rarely get a seat at the table when the landlord and its lender negotiate the loan and lenders rarely at the table when the landlord and tenant negotiate the lease.

a. *Landlord's Lender Fails*. To induce a highly desirable tenant to sign its lease, landlord agrees to fund a generous multi-million-dollar TI Allowance and significant brokers' commissions. Landlord, or an affiliate of landlord, takes out a line-of-credit to fund the TI Allowance and other concessions, such as remodeling common areas, restrooms, and the like. The economy turns abruptly, the lender fails, and funding under the line of credit abruptly stops. The Landlord does not have the cash to pay the TI Allowance as and when due under the lease, and the lender isn't able to fund the loan? What are the landlord and the tenant to do? Does the FDIC have to fund the loan made by the failed bank? If the FDIC sells the loan, how long will funding be disrupted? What happens if there is no buyer for the loan because the interest rates and terms for any as yet unadvanced but committed funds are no longer market? What does the lease say about such a conundrum?

b. *Landlord Defaults on its Loan*. If a landlord defaults on its loan, its lender ordinarily has a panoply of remedies, including foreclosure. Do the form lease and the SNDA really mean what each seems to say: if landlord's lender forecloses, is the tenant really obligated to continue paying rent without any right to offset, recoup, or receive credit for self-funding the unpaid TI Allowance, even though the original landlord did not fund the TI Allowance and the original parties to the lease amortized the landlord's promised but undelivered contribution into the rental rates?

4. **Deposit Insurance, *D'Oench Duhme*, and other arcane bank regulatory stuff**. To the extent that this outline and presentation touch on deposit insurance laws and regulations, supervisory commands to the insured bank, and bank closures, the limited purpose here is not to turn real estate and lending lawyers into regulatory experts but to point real estate and lending practitioners to the basic statutes, regulations, cases, and a few secondary sources that should inform the attempts to anticipate and manage

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