

4-1-2002

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Recommended Citation

Anton N. Natsis, Michael S. Greger & Michael E. McFadden, *Credit Enhancements in Commercial Leasing Transactions: Lessons Learned from the Front Lines of Dot.Com Bankruptcies and Proposed Legislative Resolutions*, 35 Loy. L.A. L. Rev. 787 (2002).

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CREDIT ENHANCEMENTS IN COMMERCIAL LEASING TRANSACTIONS:

LESSONS LEARNED FROM THE FRONT LINES OF DOT.COM BANKRUPTCIES AND PROPOSED LEGISLATIVE RESOLUTIONS

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The authors would like to thank the editors and staff of the *Loyola of Los Angeles Law Review*.

I. INTRODUCTION

The recent dot.com “death watch” has forced office building landlords to reassess the feasibility of leasing to High-Tech/dot.com tenants. High-Tech tenants generally do not possess the qualities of a “creditworthy” tenant—that is, those tenants with a significant operating history, substantial tangible assets, and a meaningful net worth.¹ Consequently, landlords are unable to lease to such tenants unless these High-Tech tenants post financially secure, liquid credit instruments in order to enhance the liquidity and creditworthiness of their lease obligations.² Credit instruments allow landlords to lease space to credit-risky tenants based upon the financial backing of a presumably financially solvent third-party financial institution.

The significant rise in corporate—particularly High-Tech—bankruptcies, however, has caused landlords to further analyze whether their bargained-for credit enhancement can survive the bankruptcy process.³ This Article will address several issues that affect the enforceability of lease credit enhancement instruments which arise when a tenant files for bankruptcy. These issues have come into focus in several significant recent High-Tech bankruptcies where national landlords were threatened or saddled with significant

1. See generally James R. Stillman, *Counseling the Letter of Credit Arranger on Tenant Insolvency*, PRAC. REAL EST. LAW., Nov. 2001, at 45 (commenting on the care required for drafting reimbursement and security agreements for High-Tech companies in light of the wave of dot.com failures).

2. This phenomenon of credit enhancement is much more widespread than tenancies involving High-Tech companies (“High-Tech” usually refers to dot.com, internet-related service, biotech, and telecommunications companies). Other industries that are dependent on tenancies backed by credit enhancement include new media, traditional media, high growth companies with minimal operating history (e.g., software companies), law firms, and accounting firms. Even large firms are being required to post credit enhancement since there is no longer a partner personally liable to back up such leases due to the conversion of such entities to non-recourse entities such as LLPs and LLCs.

3. This information, and much of the other information set forth in this Article, comes from the experience and personal knowledge of the authors. The authors’ firm, Allen Matkins Leck Gamble & Mallory LLP, represents ownership entities controlling in excess of 250,000,000 square feet of office space in the western United States alone, many of which are national landlords. The authors estimate that these landlords are currently holding letters of credit in an amount in excess of \$500,000,000 from High-Tech companies in connection with between 15,000,000 and 20,000,000 square feet of space in the western United States.

financial hardship. Accordingly, many national landlords are now questioning whether it is prudent in the future to enter into *any* lease with a High-Tech tenant no matter how well secured such lease is by credit enhancement.⁴ This sentiment is rapidly increasing as more and more High-Tech companies experience financial problems, enter into bankruptcy, and threaten to stifle the landlord's ability to realize the tenant's lease security. It is vital that urgent action be taken to clear up these bankruptcy enforceability impediments before national landlords form deep-seated policies adverse to High-Tech tenants.

This Article will review the impact of the Bankruptcy Code⁵ (the Code) as it affects the rights of commercial landlords holding credit enhancements to secure their leases. It also proposes amendments to the Code to protect against inconsistent court rulings and to otherwise promote leasing to High-Tech companies. This Article does not seek to change the purpose or intent of any provision of the Code—rather, it only seeks to clarify Congress' original intent in adopting the Code. Finally, this Article will offer practical tips to landlords that are already, or soon will be, facing financially-challenged High-Tech tenants.

II. STRUCTURING CREDIT ENHANCEMENT

Historically, sophisticated landlords have tried to enter into leases only with "creditworthy" tenants.⁶ With such tenants, landlords have relied upon the tenant's signature, or that of an affiliated guarantor, to satisfy the landlord's credit concerns.⁷ Since High-Tech tenants do not possess "creditworthy" qualities and almost always have no true parent company, they are, almost as a rule, required to post financially secure, liquid credit instruments to back up their lease obligations. Landlords have demanded that such credit instruments be capable of liquidation in a highly expedited fashion upon a tenant default.⁸ There are several types of credit enhancement instruments, each with significantly different qualities and varying degrees of acceptability in the landlord community.

4. See *supra* text accompanying note 3.

5. See 11 U.S.C. §§ 101-1330 (2000).

6. See Stillman, *supra* note 1 (discussing the qualities of a "creditworthy" tenant).

7. See *supra* text accompanying note 3.

8. See *supra* text accompanying note 3.

A. Letters of Credit

1. General terms

The most widely used and accepted method of credit enhancement in a High-Tech lease is an irrevocable letter of credit (L-C). An L-C is a written undertaking issued by a financial institution that is essentially a promise to pay money to the landlord/beneficiary upon notice to the beneficiary that a tenant-oriented lease default has occurred.⁹ The tenant's agreement that a default has occurred is not required.¹⁰ The tenant pays the financial institution a fee to issue the L-C and collateralizes the L-C with assets that have varying degrees of liquidity. Although the use of letters of credit arise in a number of commercial situations, in the commercial lease context, landlords often seek to substitute a bank's financial integrity or reputation for that of a tenant, particularly with regard to High-Tech tenants. Such leases are usually structured to allow the landlord to draw on the full amount or any portion of the L-C to compensate the landlord for any damages it may suffer in the event that the tenant defaults under the lease.

Once an L-C is issued, the issuer becomes statutorily obligated to honor drafts drawn by the beneficiary that comply with the terms of the credit.¹¹ Indeed, under longstanding commercial law, the obligation of the issuer to the beneficiary under the L-C is completely independent and distinct from the applicant's obligation on the underlying contract, the lease, to the beneficiary.¹² This independence principle has been recognized as the cornerstone of L-C law.¹³ Put another way, the issuer must pay on a proper demand from the beneficiary even though the beneficiary may have breached the underlying contract with the applicant.

9. See U.C.C. § 5-102(a)(10) (2000).

10. See Stillman, *supra* note 1, at 51.

11. See U.C.C. § 5-108(a) (2000).

12. See U.C.C. § 5-103(d) (2000); see also Demczyk v. Mutual Life Ins. Co. (*In re* Graham Square, Inc.), 126 F.3d 823, 827 (6th Cir. 1997) (holding that a bankruptcy trustee could not recover a commitment fee for an unconsummated loan which the debtor's bank paid to the lender against the debtor's standby letter of credit).

13. See Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 590 (5th Cir. 1987); see also *In re* Graham Square, Inc., 126 F.3d at 827-28.

The qualities of an L-C are best understood by studying the perspective of each of the parties to the lease transaction towards the instrument. As with all credit enhancement, the landlord is searching for the instrument that is most readily converted into cash, as it has the highest probability of being honored by the issuer of the instrument, and is unlikely to be substantially affected by a bankruptcy of the tenant. An appropriately drafted L-C has all of these qualities.

In most instances, the only drawbacks of L-Cs relate to common administrative issues.¹⁴ The term of an L-C is usually one year and automatically renews annually. Landlords will typically require an express provision in the L-C stating that such L-C is only able to lapse if the landlord/beneficiary is given an opportunity to draw the L-C by receiving adequate prior notice of the non-renewal from the issuer. This creates problems for landlords who do not adequately review nonrenewal notices, since their security will lapse prior to the expiration of the lease term. Additional problems arise because landlords do not take precautions to retain possession of original L-Cs, and cannot present them when necessary to make a draw.

Additionally, there are some restrictions on the transfers of L-Cs by beneficiaries—for instance, which transfers are necessary when the lease is transferred. Such transfers require delivery of the original L-C to the bank for reissuance to a new beneficiary and often require the payment of a substantial transfer fee.¹⁵

When analyzing credit instruments, tenants are concerned about the cost of the instrument and the amount of assets required to collateralize the issuance of the instrument. Traditionally, an L-C did not require anything close to one hundred percent cash collateral as security.¹⁶ However, lenders have lately come under pressure from regulators to tighten credit/collateral requirements; such pressure has tilted towards higher or total coverage by cash collateral or other fairly liquid collateral.¹⁷ From a cost perspective, the fee for

14. For an example of administrative issues, see *infra* Part V.A.6.

15. The requirements set forth herein are the most common. The actual requirements to transfer an L-C will be set forth within such L-C.

16. See Stillman, *supra* note 1, at 47, 53-55.

17. See Janet C. Norris, *Letters of Credit Posted by Dot-com Tenants—How Lenders Can Avoid Becoming a Victim of Tulipmania*, CAL. REAL PROP. J., Spring 2000, at 5.

an L-C, which could be as low as one-half of a percent, is very tolerable. This is especially true given that, in connection with a cash security deposit, most landlords remain reluctant to pay anything close to a market rate of interest.

2. Drafting and negotiation considerations

There are several drafting and negotiation issues related to L-Cs that must be properly addressed to give the landlord the full anticipated benefits of an L-C.¹⁸ The L-C should be drawable simply upon a certification from the landlord stating that such moneys are due and owing under the lease without requiring any tenant input or certification. The landlord should be able to draw on all or any portion of the L-C to cure a default, and then to apply the remaining drawn portion against the landlord's future damages stemming from the default.¹⁹ This is necessary so that a landlord does not have to make repeated draws on a perpetually delinquent tenant. The L-C, which is typically for a term of one year only, must automatically renew unless notice is given to the landlord, and must have an ultimate renewable term that exceeds the expiration of the lease by at least sixty days. This will allow the landlord to assess any holdover or restoration obligations of the tenant. In the event the tenant files for bankruptcy within ninety days of lease termination, the landlord should be given the right to draw on the L-C for the amount of any payments made within the preference period in order to guard against the risk of the inevitable preference claim. The L-C must be transferable to lenders and subsequent landlords, and it should state the fee for such transferability or that no fee is payable. Otherwise, if left silent, the issuer will most likely impose a significant transfer fee at the time of a request for transfer. Copies of the exact documents necessary to draw on the L-C should be attached to the L-C, so that there is no question that a proper draw request has been made.

There are a number of additional issues that relate to the status of the issuing bank itself. It should not be assumed that every issuing

18. See *infra* Attachment Number One for a model lease provision and form of L-C from a landlord's perspective.

19. The underlying lease and L-C must carefully define events of default in order to avoid issues stemming from the automatic stay. See *infra* Part III.B.2.a.

bank has the necessary financial ability to stand behind each L-C it issues. In the case of larger, longer term L-Cs, the financial capabilities of the issuer should be scrutinized. This can be accomplished by requesting financial information from the issuing bank or by reviewing the issuing bank using a bank rating service.²⁰ The location of the issuing bank is also an important factor. The landlord should insist upon a bank that has a local branch that will negotiate the L-C, or in the case of an out-of-state or nondomestic bank, the use of a local bank that will stand behind the L-C.²¹ These issues are important since out-of-state or nondomestic banks can be tougher to financially analyze. Also, L-C draws are always better handled on a face-to-face basis since time will be of the essence and the draw process is not always an exact science.

B. Lease Bonds

1. General terms

A lease bond is a credit instrument that is a promise by a surety to pay the debt of the tenant upon demand by the landlord.²² However, a lease bond should not be mistaken as containing the same qualities as an L-C. A lease bond represents only a promise from the surety to pay and is not susceptible to liquidation in the same manner or as expeditiously as an L-C. In fact, it is not uncommon for a lease bond to be enforced only after a lengthy legal battle, and any legal fees incurred by the landlord would only serve to reduce the proceeds recovered under the bond. Accordingly, due to liquidity concerns, landlords almost always prefer L-Cs over lease bonds.

The qualities of a lease bond are best understood by analyzing the viewpoints of each of the parties to the lease transaction towards the instrument. The landlord views a lease bond as a third-party

20. For example, Fitch, Inc. is an excellent financial institution rating service that provides extensive information on a number of domestic and international issuers of L-Cs. See Fitch, Inc., Fitch Ratings, at <http://www.fitchibca.com> (last visited Feb. 18, 2002).

21. It is not uncommon for an L-C issued by an out-of-state or nondomestic bank to be "confirmed" by a local bank. This confirmation is reflected in an additional document from the confirming bank. This amounts to a promise to honor the L-C if the issuer does not do so.

22. See Stillman, *supra* note 1, at 51-54.

guaranty of its lease obligations. The financial capabilities of the surety company can be easily ascertained since most surety companies have published ratings.²³ The problems for a landlord relate to the differences between the enforcement of an L-C as opposed to a lease bond.²⁴

From a tenant's prospective, the lease bond will cost about the same as an L-C.²⁵ However, the collateral requirements might be less onerous since a surety company is in many instances a much more aggressive underwriter than a traditional L-C bank.²⁶

2. Drafting and negotiating considerations

Landlords must pay very strict attention to several problems that could arise in connection with surety bonds.²⁷ Assuming the bonding company is satisfactory, the key concern is that once a tenant—the principal under the bond—defaults, obstacles may stand in the way of a landlord actually collecting on the bond. First, while a lease bond may be easier to collect on than a simple corporate or individual guaranty (because of the reputation and rating of the bonding company), unless the landlord enjoys certain protections under the express language of the lease or lease bond, it will be equivalent to a corporate guaranty upon which the landlord must sue, overcome any defenses by the principal or the obligor, obtain a judgment, execute on that judgment, and collect the amount of its claim. Accordingly, the landlord should require a form of lease bond that reflects many of the same protections afforded by an L-C.

The language of the lease bond should provide that in the event of a default, the landlord may make a demand on the surety and the surety will voluntarily pay the amount demanded within thirty days. However, sections 2802-2810, 2845, 2849, 2850, and 2855 of the California Civil Code provide certain protections for sureties. For example, California Civil Code section 2845 states:

23. For instance, many surety companies are rated in Best's Insurance Reports. See A.M. Best Ratings & Analysis, at <http://www.ambest.com/ratings/index.html> (last visited Feb. 12, 2002).

24. See *infra* Part II.B.2.

25. See *supra* text accompanying note 3.

26. See *supra* text accompanying note 3.

27. See *infra* Attachment Number Two for a model lease provision and form of lease bond from a landlord's perspective.

A surety may require the creditor, subject to Section 996.440 of the Code of Civil Procedure, to proceed against the principal, or to pursue any other remedy in the creditor's power which the surety cannot pursue, and which would lighten the surety's burden; and if the creditor neglects to do so, the surety is exonerated to the extent to which the surety is thereby prejudiced.²⁸

Obviously, protections such as these would frustrate a landlord's ability to have a quick and unconditional remedy in the event a tenant defaults. Therefore, the lease bond should provide for an express waiver by the surety of all such protections specifically referenced by statute.

Furthermore, in response to a claim, the surety may attempt to raise defenses that would be held by the tenant. The simplest example is that the surety would respond that it has been advised by the tenant that it is not in default and that the claim is therefore not valid. Again, the lease bond should make absolutely clear that the claim, once made in the appropriate form, cannot be disputed by the surety based on defenses that may be asserted by the tenant, and that an immediate and unconditional payment of the entire bond amount must be made to the landlord.²⁹

Related to the previous point is the amount of the claim that can be demanded, assuming that the past due amounts under the lease are only a fraction of the total bond amount. By normal operation, the landlord could only make a claim for the amount actually in default. The surety, if it chose to do so, would voluntarily make the payment, and the bond amount would simply be reduced to reflect the credit for the claimed amount. However, for several reasons—not the least of which is that the landlord should not be forced into making a series of claims month after month should the tenant remain in default—the language of the bond should provide that upon a default, the landlord may demand the entire bond amount even though the actual arrearage under the lease at that time may be less than the full bond amount. The lease should provide that the landlord has the option of using these funds to cure any existing

28. CAL. CIV. CODE § 2845 (West 1993 & Supp. 2002).

29. See *supra* text accompanying note 27.

defaults, to compensate it for any other damages or costs incurred, or to hold such funds as security for future performance under the lease.

Finally, in the absence of any language to the contrary, unless the surety voluntarily pays a claim as demanded, a landlord would be forced to initiate a lawsuit against the surety to establish liability under the bond. Such a lawsuit would present serious timing and expense concerns for the landlord. Accordingly, express language should be included in the lease bond to reinforce the fact that the surety must honor the demand unconditionally; that no action need be brought on the lease bond to satisfy the claim; and that, thereafter, once the surety has honored the claim, the surety may assert any defenses it has against the landlord to receive amounts which were not actually owed. Further, the bond should state that if the surety does not honor such an initial claim and a legal action must be brought to enforce such initial claim (as opposed to a legal action by the surety to recover amounts paid to the landlord), the bonding company would be liable to the landlord for all attorneys' fees and costs incurred, whether or not such lawsuit ultimately results in a judgment.

C. *Certificates of Deposit*

Certificates of deposit are the newest type of collateral given by High-Tech tenants. The instrument is a certificate of deposit issued by a financial institution in the name of the landlord. It is unconditionally payable to the landlord upon demand, funded by the tenant, and automatically renewed for the length of the lease term. The principal amount accrues to the benefit of the landlord and the interest is payable to the tenant.³⁰ The landlord must make sure that the principal amount is sufficient so that any penalties for early withdrawal will not reduce the principal below the desired security amount. The instrument has a one hundred percent cash collateral requirement for the tenant, but is at no cost to the tenant other than

30. See *infra* Attachment Number Three for a model form of certificate of deposit from a landlord's perspective. Model lease language for use with such forms of certificates of deposit can easily be derived by slight modifications to the model lease language used for L-Cs or bonds as set forth in *infra* Attachments Number One and Two, respectively. Since the certificate of deposit secures the lease, landlords must ensure that they properly perfect their security interest in the certificate of deposit pursuant to Article 9 of the U.C.C.

the imputed costs of such collateralization and the penalties that could be incurred for early withdrawal.

D. Cash

Traditionally, cash has been the most often given type of collateral as a security deposit. However, in connection with larger security deposits, landlords are reluctant to accept cash due to bankruptcy implications.³¹

III. BANKRUPTCY/STATE LAW LIMITATIONS AFFECTING LANDLORD RECOVERIES

In order to correctly structure credit enhancements, a landlord must have a full understanding of the bankruptcy and state law limitations that restrict their damages in the event of a lease termination.

A. Analysis of State Law Limitations on Lease Termination Damages³²

In general, if the tenant defaults under the terms and conditions of the lease, the landlord has two alternatives. First, the landlord can treat the default as a termination of the lease and sue for damages.³³ As part of the landlord's claim, the landlord is entitled to all unpaid rent up until the lease termination, plus the amount of rent that would have been earned from the termination until the time of judgment (less mitigation), plus the amount by which unpaid rent for the balance of the lease term after the time of judgment exceeds the amount of lost rent the tenant proves could reasonably have been avoided by the landlord, discounted at the discount rate of the Federal Reserve Bank of San Francisco at the time of the judgment, plus one percent addition to the costs incurred to create such mitigation.³⁴ Second, and in the alternative, if expressly provided in the lease, the landlord may elect by notice to continue the lease in

31. See *infra* Part III.B.3.

32. The analysis of state law limitations on lease termination damages is based on California law.

33. See CAL. CIV. CODE § 1951.2 (West 1985 & Supp. 2002).

34. See *id.*

effect and recover the rent periodically in separate lawsuits as it becomes due.³⁵

Simply stated, if a tenant breaches the lease at its inception and the landlord terminates the lease, the landlord would be entitled to assert a damage claim against the tenant equal to the net present value of future rents due and owing under the lease, less the amount of rent that the landlord would recover by releasing the property to a third party, plus the costs incurred to create such mitigation. Although the formula is simple, application of the formula in the courts has been inconsistent and unpredictable.³⁶ In the event the tenant breaches the lease at its inception, a state court would not likely award the landlord the full statutorily mandated amount, but would probably award a lesser sum. Furthermore, if the tenant were in bankruptcy, the landlord's damages would be the lesser of either the actual damages under state law or the amount of the cap under § 502(b)(6).³⁷

B. Analysis of Bankruptcy Limitations on Lease Termination Damages

1. The amount of the claim against tenant

Under § 365 of the Bankruptcy Code, a debtor/tenant has the option to either assume or reject an unexpired lease of real property.³⁸ In order to assume the unexpired lease, the trustee must cure all outstanding defaults and provide adequate assurance of future performance.³⁹ If the tenant decides to reject the lease, or if the lease is deemed rejected by operation of bankruptcy law, the landlord will be entitled to assert a claim for any lease rejection damages it suffers.⁴⁰ The landlord's lease rejection damages are calculated under state law without regard to any bankruptcy limitations.⁴¹ Section 502(b)(6)(A) of the Bankruptcy Code,

35. See CAL. CIV. CODE § 1951.4 (West 2001).

36. See *In re Atl. Container Corp.*, 133 B.R. 980, 990 (Bankr. N.D. Ill. 1991).

37. See 11 U.S.C. § 502(b)(6) (2000).

38. See 11 U.S.C. § 365(a) (2000).

39. See 11 U.S.C. § 365(b)(1)(A) (2000).

40. See 11 U.S.C. § 365(g) (2000).

41. See *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 96 (B.A.P. 9th Cir. 1995) (finding that a landlord's damages are determined by state law).

however, artificially caps the landlord's rejection damages at "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease."⁴²

There is some debate as to what constitutes rent for purposes of calculating the cap under § 502(b)(6). For example, some courts conclude that the term only includes fixed and regular payments, thus excluding such charges as general maintenance or utilities.⁴³ At least one court in the Ninth Circuit, the appellate district that controls in California, has adopted the following tests to determine what constitutes "rent reserved":

- 1) The charge must: (a) be designated as "rent" or "additional rent" in the lease; or (b) be provided as the tenant's obligation in the lease;
- 2) The charge must be related to the value of the property or the lease thereon; and
- 3) [T]he charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.⁴⁴

Presumably, under this definition, the term "rent reserved" in the context of a triple-net or base-year lease would include minimum rent, parking charges, real estate taxes, insurance, and common area maintenance fees owed by tenant. Unfortunately, however, because the courts have not yet resolved this issue, the exact cap that a bankruptcy court would ultimately apply is uncertain and depends upon the jurisdiction in which a particular case is filed. The cap should include, however, minimum rent, parking charges, taxes, and insurance.

Finally, it is important to note that all damages resulting from the tenant's termination of the lease are subject to the cap under § 502(b)(6). In addition to unpaid rent, additional damages that are subject to the cap would include any obligations of the tenant to restore or demolish the premises at the end of its lease term. However, damages the landlord may suffer that are unrelated to lease

42. 11 U.S.C. § 502(b)(6)(A) (2000).

43. *See, e.g., In re Rose's Stores, Inc.*, 179 B.R. 789 (Bankr. E.D.N.C. 1995) (finding that taxes and insurance were included and general maintenance and utility charges were excluded from the claim amount).

44. *McSheridan*, 184 B.R. at 99-100.

termination, such as those resulting from the debtor's neglect of the premises, may be outside the cap.

2. Effect of bankruptcy law and the cap on letters of credit

Because of the independence principle,⁴⁵ most bankruptcy courts have held that an L-C and its proceeds are not property of a debtor/applicant's bankruptcy estate.⁴⁶ Such courts have reasoned that the funds paid under an L-C are funds belonging to the issuer and not the applicant/debtor and, therefore, cannot be property of the bankruptcy estate. However, a small minority of bankruptcy courts have held otherwise.⁴⁷ By holding that the L-C is property of the debtor's bankruptcy estate, such courts have held that an automatic stay, discussed below, prevents the beneficiary from drawing against the L-C following a bankruptcy filing. In other words, if a landlord is unlucky enough to find itself before a court adopting the minority position, it could be enjoined from drawing on an L-C and lose the benefit of the L-C altogether.

a. the automatic stay

Section 362 of the Code stays all actions against the debtor or efforts to recover property of the debtor upon the filing of a bankruptcy petition.⁴⁸ The purpose of the stay is to give the debtor a breathing spell from its creditors. Because of its broad reach, the automatic stay enjoins virtually all actions taken by a landlord to enforce its lease subsequent to a bankruptcy filing. For example, the automatic stay prohibits a landlord from sending notice of default to

45. See *infra* Part V.A.2.

46. See, e.g., *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 589 (5th Cir. 1987) (finding that, under the independence principal, the obligation of the issuer of the L-C was independent from obligations between the beneficiary of the L-C and the issuer's customer); see also *Musika v. Arbutus Shopping Ctr. Ltd. P'ship (In re Farm Fresh Supermarkets of Md., Inc.)*, 257 B.R. 770, 772 (Bankr. D. Md. 2001) (finding that L-Cs were not included in the property of the estate).

47. See, e.g., *Twist Cap, Inc. v. S.E. Bank (In re Twist Cap, Inc.)*, 1 B.R. 284 (Bankr. M.D. Fla. 1979) (granting bankruptcy court jurisdiction for a complaint filed by a debtor seeking an order to restrain the bank from honoring letters of credit, despite the contention that the L-Cs were not properties of the debtor, where the L-Cs were secured by properties of the debtor).

48. See 11 U.S.C. § 362(a) (2000).

the tenant following a bankruptcy filing or demanding payment of prepetition rent.

The broad reach of the automatic stay creates potential difficulties for landlords attempting to draw on L-Cs following their tenant's bankruptcy filing. First, if the bankruptcy court were to ignore generally accepted commercial law principles and find that the L-C is property of the debtor's bankruptcy estate, the automatic stay would enjoin any effort to draw on the L-C. Second, commercial real estate leases often restrict a landlord's ability to declare a default until notice of default is first delivered to the tenant and the tenant fails to cure such default within a specified cure period. Where no notice of default was sent to the tenant prior to the tenant's bankruptcy filing, the automatic stay may enjoin the landlord from delivering any notice of default or declaring a default.⁴⁹ Consequently, the landlord, who is unable to declare a default by virtue of the automatic stay, may be unable to draw under an L-C since such draws are typically triggered by the tenant's default.⁵⁰

b. ipso facto defaults

Section 365(e) of the Code prohibits the enforcement of contractual provisions declaring defaults against a debtor as a result of the debtor's bankruptcy filing or insolvency.⁵¹ Such contractual provisions are commonly referred to as "ipso facto" clauses. Bankruptcy courts are split over whether § 365(e) serves to invalidate ipso facto clauses altogether, or simply serves to make them unenforceable against the debtor.⁵² If § 365(e) is determined to

49. See *In re Metrobility Optical Sys., Inc.*, 268 B.R. 326 (Bankr. D.N.H. 2001).

50. In addition to the inability to draw, other potential harm may result to the landlord. For example, in *In re Darwin*, United States Bankruptcy Court Case Nos. 01-0095 and 01-0096 (JCA), the landlord drew on an L-C even though no prepetition default had occurred. The court held that the proceeds of the draw had to be applied to the landlord's postpetition administrative claim. See *Darwin Networks, Inc. v. NPE Assets Mgmt., L.P. (In re Darwin Networks, Inc.)*, Case Nos. 01-0095 and 01-0096 (JCA) (Bankr. D. Del. Aug. 24, 2001). Normally, under § 365(d)(3) of the Code, the tenant is obligated to pay this claim in cash postpetition. See 11 U.S.C. § 365(d)(3) (2000).

51. See 11 U.S.C. 365(e) (2000).

52. Compare *In re Metrobility*, 268 B.R. at 329-30, with *Zenith Labs, Inc. v. Sec. Pac. Nat'l Trust Co. (In re Zenith Lab., Inc.)*, 104 B.R. 667 (Bankr. D.

invalidate such clauses altogether, then a landlord will not have a right to draw against an L-C based upon its tenant's bankruptcy filing even though such a right was bargained for and expressly granted in the L-C documents.

c. limitation of landlord's damages

The cap imposed by § 502(b)(6) raises a question regarding whether the debtor or a third party, that is, the issuer of an L-C, may use the § 502(b)(6) limitation to (1) limit such third party's obligation to the landlord, or (2) require the landlord to disgorge any amount drawn against an L-C that exceeds the § 502(b)(6) cap. In other words, does the limitation on the amount of damages that a landlord may claim against *the debtor's estate* also serve to limit the independent obligation that a third-party obligor owes to a landlord?⁵³

Although an L-C is not a guarantee, it is in many ways analogous to a guarantee since both provide for third-party security of a lease. With respect to guarantees, courts have consistently held that a guarantor, who is itself not a debtor, cannot avail itself of § 502(b)(6) as a defense to full payment under a guarantee. In this respect, there is no reason to treat an L-C differently from a guarantee. An L-C, like a guarantee, is an independent contract between the landlord and the issuer, i.e., a bank.⁵⁴ Because of the independence principle,⁵⁵ the debtor does not have a property interest in the L-C.⁵⁶ Without a property interest in the L-C, the debtor, consequently, does not retain a property interest in the proceeds from the L-C and the trustee of the bankruptcy estate should not have the right to either (1) enjoin a landlord's ability to draw against an L-C in excess of the § 502(b)(6) cap, or (2) require a landlord to disgorge any proceeds from the L-C that exceed the § 502(b)(6) cap.⁵⁷

N.J. 1989).

53. See *Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.)*, 900 F.2d 1184, 1191 (8th Cir. 1990).

54. See *Hall v. Goforth (In re Goforth)*, 179 F.3d 390 (5th Cir. 1999).

55. See discussion *supra* Part II.A.1.

56. See *In re Farm Fresh Supermarkets*, 257 B.R. at 772.

57. To date, no court in the country has published any opinions on this issue. The Bankruptcy Court for the District of Delaware, however, in *In re Darwin Networks, Inc.*, recently decided this issue in an unpublished opinion and held that, because the letter of credit proceeds are not estate property, §

It should be noted that a landlord's draw against an L-C in excess of the § 502(b)(6) cap does not frustrate the purpose of the cap. Subsequent to the landlord's draw, the issuer of the L-C, i.e., the bank, has a claim against the debtor's bankruptcy estate equal to the amount of landlord's draw. The debtor may still attempt to argue that the bank's claim is capped by § 502(b)(6) and, therefore, protects the debtor's bankruptcy estate as intended by the drafters of the Code. However, since the landlord is able to draw up to the full amount of the L-C while the bank's claim may be limited by § 502(b)(6), the bank and not the landlord is assuming the risk of the tenant declaring bankruptcy. This result is consistent with the intent of the L-C and is the intended assumption of risk that was negotiated by the parties at the time the L-C was issued.

d. preferential transfers

Under § 547 of the Code, a party that receives a payment from the debtor on account of an antecedent debt may be forced to disgorge that payment as a preferential transfer.⁵⁸ The purpose of this section of the Code is to prevent the debtor from favoring one creditor over other similarly situated creditors.⁵⁹ The preference statutes, however, raise several issues for landlords holding L-Cs to secure their leases.

i. proceeds from a letter of credit

If a landlord draws on an L-C within the preference period, select courts may find that the landlord has received a preferential transfer.⁶⁰ This ruling, however, is incorrect. Because the L-C is not property of the debtor's bankruptcy estate, by definition, there has been no transfer of the debtor's assets.⁶¹ Accordingly, no preferential transfer could have occurred. The Code should be clarified to provide that since an L-C is not property of the debtor's

502(b)(6) cannot be used to seek to turnover or disgorge such proceeds. *See In re Darwin Networks, Inc.*, Case Nos. 01-0095 and 01-0096 (JCA) (Bankr. D. Del. Aug. 24, 2001).

58. *See* 11 U.S.C. § 547 (2000).

59. *See id.*

60. *See In re Twist Cap*, 1 B.R. at 285.

61. *See In re Compton Corp.*, 831 F.2d at 589.

bankruptcy estate, any payment from or draw against an L-C cannot, as a matter of law, be classified as a preferential transfer.

ii. payments in lieu of an L-C draw

At least one circuit court has held that a landlord may be sued for receiving preferential transfers from the debtor even though the landlord was fully secured under the terms of an L-C for the amounts of the payments received.⁶² Because of the unfairness of this ruling, landlords may be required to return payments they have received during the preference period even though, if the debtor had defaulted in its payments, the landlord had the right to draw on an L-C for the full amount of such payments and avoid preference liability altogether. The Code should be clarified to provide that where an original transfer was secured by an L-C, the transfer cannot, as a matter of law, be classified as a preferential transfer.

iii. preferences resulting from an increase in collateral securing an L-C

In order to obtain an L-C, an applicant is typically required to secure its obligation to reimburse the issuer by granting the issuer a security interest in certain of the applicant's assets—typically cash or a certificate of deposit in the case of High-Tech tenants.⁶³ Under preference laws, an issue arises where the applicant either increases the amount of collateral securing the L-C or provides security to the issuer to secure an existing L-C during the preference period. Courts will deem a grant of a security interest to constitute a transfer of assets for purposes of preference laws. If the transfer—that is, the grant of a security interest—occurs during the preference period on account of the applicant's existing obligation to reimburse the issuer under an L-C or to further secure an existing L-C, then the debtor may avoid the transfer against the issuer. In addition, under § 550(a)(1) of the Code, the debtor may also sue and potentially recover from the beneficiary of the L-C on the grounds that the beneficiary was “the entity for whose benefit such transfer was

62. See *Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (In re Powerline Oil Co.)*, 59 F.3d 969, 972 (9th Cir. 1995).

63. See *supra* text accompanying note 3.

made.”⁶⁴ In other words, even though the beneficiary is holding an L-C that was issued outside of the preference period, the beneficiary may still face preference exposure based upon a transfer made to the issuer. This result voids the benefits and protections afforded the landlord from an L-C.

e. equitable powers of the bankruptcy courts

Section 105 of the Code grants the bankruptcy court general equitable powers to issue any order that promotes the purpose of the Code.⁶⁵ Some courts have used this section to enjoin draws against L-Cs on the theory that such draws would materially affect the debtor’s bankruptcy estate, while others have found that the L-C is not an asset of the debtor’s bankruptcy estate.⁶⁶ Section 105, however, was enacted to further the purpose of the Code, not to grant courts jurisdiction over assets that do not belong to the estate. The Code should, therefore, be clarified to provide that an L-C is not part of the debtor’s bankruptcy estate and, accordingly, a bankruptcy court may not enjoin a draw against an L-C for any reason related to the debtor’s bankruptcy filing.

3. Effect of bankruptcy law and the cap on cash security deposits

The impact bankruptcy may have on a landlord’s security is best understood by analyzing the bankruptcy issues relating to a landlord’s acceptance of a cash security deposit. A cash security deposit in bankruptcy creates two primary issues for the landlord. First, if the security deposit has not been applied by the landlord prior to the bankruptcy filing, then the cash security deposit would automatically become an asset of the debtor’s bankruptcy estate, and the automatic stay would prohibit the landlord from attempting to offset the security deposit against his damages without first obtaining relief from the automatic stay—even if the lease is ultimately rejected by the tenant.⁶⁷ Assuming the cash security deposit does not

64. 11 U.S.C. § 550(a)(1) (2000).

65. See 11 U.S.C. § 105 (2000).

66. See *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. New Jersey (In re Prime Motor Inns, Inc.)*, 123 B.R. 104 (Bankr. S.D. Fla. 1990) (compelling the return of funds drawn under an L-C under § 105).

67. See *In re Atl. Container Corp.*, 133 B.R. 980, 989 (Bankr. N.D. Ill. 1991).

exceed the bankruptcy cap or the landlord's state law damages, the landlord would likely have a secured claim equal to the amount of the security deposit and an unsecured claim for any deficiency.⁶⁸ Thus, while the landlord's damage claim would likely be secured, the landlord may be enjoined for extended periods by virtue of the automatic stay from seeking to offset its damage claim against its security deposit creating serious cash flow issues for the landlord.

Second, and more problematic, the landlord may be forced to disgorge a cash security deposit to the extent that the security deposit exceeds its maximum allowable damages under § 502(b)(6).⁶⁹ Although § 502(b)(6) does not address this point, its legislative history and case law make clear that the amount of a security deposit that exceeds the 502(b)(6) cap must be returned to the bankruptcy estate.⁷⁰ Given this legislative and case authority, the landlord should avoid any cash security deposit in an amount in excess of the cap if the tenant poses a bankruptcy risk since any amount over and above the cap may be of no value to the landlord.⁷¹

IV. CHANGES TO MAKE THE BANKRUPTCY CODE WORK BETTER

Based upon the foregoing analysis, the following Code modifications are recommended. The recommended modifications are minor in nature and do not abrogate any significant longstanding debtor-protection principles of the Code nor do they undermine any underlying policies of the Code. These modifications are directly aimed at clarifying issues related to the enforceability of L-Cs, and thereby promoting leases to High-Tech companies by national landlords.

68. *See id.*

69. *In re PPI Enters., Inc.*, 228 B.R. 339 (Bankr. D. Del. 1998).

70. *See In re Atl. Container Corp.*, 133 B.R. at 989 (citing S. REP. NO. 95-989, at 63 [sic] (1978); H.R. REP. NO. 95-595, at 353 [sic] (1977), in finding that "a lessor's 'security deposit will be applied in satisfaction of the claim that is allowed under [§ 502(b)(6)]'").

71. We are not advocating that the landlord should limit the total amount of credit enhancement to an amount equal to the § 502(b)(6) cap, only that any amount in excess of the cap should be in a form more likely to survive a tenant bankruptcy.

A. Debtor's Bankruptcy Estate

Clearly, the determination that an L-C is property of the bankruptcy estate, even though the debtor is not the beneficiary, would upset both the independence principle and longstanding commercial law. To address this issue, § 541 of the Code should be amended to exclude from the definition of property of the estate any L-C where the debtor is not the express beneficiary.

PROPOSED BANKRUPTCY CODE CHANGES

Section 541(b) of the Bankruptcy Code should be amended to add the following:

- (6) any interest in an irrevocable letter of credit, or the proceeds thereof, that the debtor is not a beneficiary of.

B. The Automatic Stay

Although the Bankruptcy Code was never intended to protect third-party obligors, the current ambiguity in the Code is creating this very result. Since the purpose of the stay is to protect the debtor and its assets, not third parties, a landlord should not be enjoined from declaring its tenant in default solely for the purpose of pursuing that default against a third party, for example, the issuer of an L-C. The Code should be amended to clarify the rights of the landlord against the issuer of an L-C. For example, § 362 of the Code should be amended to provide that the automatic stay does not prohibit the delivery of a notice of default or the declaration of a default solely to trigger rights against third parties, such as the issuer of an L-C. Likewise, § 365 of the Code could be amended to clarify that the ipso facto provisions do not, in any way, restrain or restrict a lessor's rights against third parties based upon the debtor's bankruptcy filing or insolvency.

PROPOSED BANKRUPTCY CODE CHANGES

Section 362(b) of the Bankruptcy Code should be amended to add the following:

(19) under subsection (a) of this section, of any draw, demand for payment, presentment, or actual payment under an irrevocable letter of credit that is not property of the estate; or

(20) under subsection (a) of this section, of any action to notify or declare the debtor in default under any lease or contract solely for purposes of enforcing such default against persons other than the debtor, including against the issuer of an irrevocable letter of credit.

Section 365(e) of the Bankruptcy Code should be amended to add the following:

(3) paragraph (1) of this subsection does not apply to persons other than the debtor and shall not render unenforceable, restrict, or impair any right to enforce a default under a lease against a person other than the debtor, including against the issuer of an irrevocable letter of credit.

C. Limitation on Landlord's Damages

The position that § 502(b)(6) allows a court to cap the proceeds that a landlord may draw against an L-C would entirely frustrate the ability of landlords to effectively shield themselves against the risk of a start-up company's bankruptcy filing and would turn § 502(b)(6) from a claim limitation provision into an offensive weapon. Legislation should be adopted to clarify that § 502(b)(6) cannot be used in any way to enjoin, limit, or otherwise compel disgorgement of amounts lawfully drawn under an L-C.

PROPOSED BANKRUPTCY CODE CHANGES

Section 502(b)(6) of the Bankruptcy Code should be amended to add at the end of the subsection:

The disallowance of any claim (or portion thereof) pursuant to this subsection shall not limit, release, impair or otherwise restrict a lessor's damage claim against persons other than the estate, including an issuer of an irrevocable letter of credit. The estate shall have no claim, right to seek disgorgement or turnover, or other rights against a lessor for any amounts owed or paid to a lessor by any person other than the estate, including under an irrevocable letter of credit, based upon the lessor's potential or actual receipt of payment exceeding the lessor's maximum allowed claim under this subsection.

D. Preferential Transfers

Under § 547 of the Code, a party who receives payment from the debtor on account of an antecedent debt may be forced to disgorge that payment as a preferential transfer.⁷² Section 547 should be clarified to provide, that since an L-C is not property of the debtor's bankruptcy estate, any payment on an L-C cannot become the basis of a preferential transfer as a matter of law.

Likewise, the Code should be clarified to provide that, where a landlord received an actual payment in cash from the debtor at a time it was holding an L-C exceeding the amount of the payment, the landlord cannot be found to have received a preferential transfer at a later date even if the L-C expires at a date before the preference action is filed but after the payment.

Finally, the Code should be amended to prohibit suit against a landlord to recover a preference based upon the debtor's pledge of collateral or increase in collateral during the preference period.

72. See 11 U.S.C. § 547 (2000).

PROPOSED BANKRUPTCY CODE CHANGES

Section 547(a) of the Bankruptcy Code should be amended to add the following:

(5) the term "transfer" shall exclude any payment made by the issuer of an irrevocable letter of credit.

Section 547(c) of the Bankruptcy Code should be amended to add the following:

(9) to the extent such transfer was made to a person (A) who was the beneficiary of an irrevocable letter of credit at the time of the transfer; and (B) could have drawn under such irrevocable letter of credit for the amount of the transfer (or portion thereof) if the transfer had not been made.

Section 550 of the Bankruptcy Code should be amended to add the following:

(g) The trustee may not recover under subsection (a)(1) any transfer made by the debtor to an issuer of an irrevocable letter of credit from the beneficiary of such irrevocable letter of credit where such letter of credit was issued prior to 90 days before the date of the filing of the petition.

E. Equitable Powers of the Bankruptcy Courts

Section 105 of the Code grants the Bankruptcy Court general equitable powers to issue any order "that is necessary or appropriate to carry out the provisions of this title."⁷³ Courts have used this broad grant of power to, among other things, enjoin draws on L-Cs based upon the court's conclusion that such draws would materially affect the bankruptcy estate.⁷⁴ This loophole should be clarified to provide that a bankruptcy court may only seek to enjoin a draw against an L-C based upon state law or other applicable nonbankruptcy law.

73. 11 U.S.C. § 105(a) (2000).

74. *See, e.g.,* Prime Motor Inns, Inc. v. First Fidelity Bank N.A. New Jersey (*In re* Prime Motor Inns, Inc.), 123 B.R. 104 (Bankr. S.D. Fla. 1990).

PROPOSED BANKRUPTCY CODE CHANGES

Section 105 of the Bankruptcy Code should be amended to add:

(e) Notwithstanding subsection (a) of this section, a court may only enjoin or stay any draw, demand for payment, presentment, or actual payment under an irrevocable letter of credit under state or applicable nonbankruptcy law.

V. PRACTICAL TIPS

A landlord faced with a troubled High-Tech tenant has two main goals: (1) liquidate and collect the tenant's lease credit enhancement, and (2) regain possession of the premises as quickly as possible. The priority of these goals may differ depending upon the particular situation at hand, but regardless of which goal has the higher priority, the landlord's actions should be geared towards achieving the two goals collectively. The analysis and approach set forth below outline three stages upon which landlords should concentrate whenever interacting with High-Tech tenants. The three stages are: (1) structuring the lease transaction, (2) managing tenants having financial problems before a lease default, and (3) managing tenants having financial problems and are in default of the lease but not in bankruptcy.

A. Structuring the Lease Deal

One of the landlord's primary concerns when structuring the transaction is credit enhancement. A landlord must ensure that the credit enhancement (1) adequately covers the maximum amount a landlord may be damaged upon a tenant default—e.g., as if the tenant defaulted at the beginning of the lease term, (2) can be quickly converted to cash—e.g., a letter of credit as opposed to a personal guarantee, and (3) will not be reduced or limited if a tenant declares bankruptcy. The first two concerns can be easily addressed during the negotiation phase of the deal. However, because of the uncertainty in the Code, structuring the lease deal in order to maximize recoveries of credit enhancement is not an exact science. The following are the state-of-the-art strategies used by savvy landlords under the current Code.

1. General terms

The bankruptcy limitation on a landlord's lease-termination damages has existed, in one form or another, since the 1930s.⁷⁵ Since the implementation of the cap, landlords have attempted to create strategies to avoid the cap.⁷⁶ Bankruptcy courts, as courts of equity, have become attuned to these strategies and have often struck them down.⁷⁷ Thus, while strategies may be adopted in an effort to avoid the harsh effects of § 502(b)(6), there is no assurance that such strategies will ultimately prevail.

Additionally, although numerous bankruptcy courts have resolved the issue of how the cap is calculated or whether it applies to third parties such as guarantors, few, if any, courts have resolved the issue of whether a landlord can disguise or take a noncash security deposit so as to successfully steer clear of § 502(b)(6). The reason for this lack of precedent is simple: historically, it has been rare that a commercial tenant would post as security an amount that substantially exceeds the cap under § 502(b)(6). However, this is typically not the case in High-Tech leases, where the amount of the credit enhancement is typically in excess of the bankruptcy cap amount. In many such leases, the amount of security is up to two years of the base rent. In any event, because of the lack of guiding precedent, the ultimate success of any strategy designed to avoid the harshness of § 502(b)(6) is uncertain. With the foregoing background, the following is a brief outline of strategies that have the best chance of surviving an attack, although such strategies are not unassailable.

2. Irrevocable standby letter of credit

Because of the unique characteristics of a letter of credit, a landlord may be able to avoid the effects of bankruptcy law, including the bankruptcy cap, by requiring that the tenant post an irrevocable standby letter of credit to guaranty its performance under the lease rather than a cash security deposit. A standby letter of credit operates to guarantee payment to the beneficiary if the account

75. See Thomas McIntyre Devaney, Comment, *The Klein Sleep Decision: Section 502(b)(6) Lease Damages Cap As the Rule, Not the Exception*, 4 AM. BANKR. INST. L. REV. 557, 572-73 (1996).

76. See *supra* text accompanying note 3.

77. See *supra* Part III.

party should default in its obligations pursuant to the underlying transaction. The standby letter of credit creates an independent contract between the issuing bank and the beneficiary of the letter of credit. Indeed, it is well established that once the beneficiary makes demand upon the issuing bank in compliance with the terms of a letter of credit, the debtor may not prevent the issuing bank from distributing the proceeds of the letter of credit, absent fraud in the underlying contract.⁷⁸ Bankruptcy courts have recognized this “independence principle” in finding that the proceeds of a letter of credit are not property of the debtor’s bankruptcy estate and that a bankruptcy court has no authority to enjoin the payment under a letter of credit.⁷⁹ This unique characteristic of a letter of credit creates an immediate advantage for a landlord—since the letter of credit is not likely property of the debtor/tenant’s bankruptcy estate, the automatic stay should not enjoin the landlord from immediately drawing down on the letter of credit.⁸⁰

More importantly, however, the letter of credit may provide the landlord with protections against the cap imposed by § 502(b)(6). Given that the issuing bank’s obligation under a letter of credit is independent from the landlord/tenant relationship, arguably, neither the bank nor the debtor can assert the cap to estop a landlord from collecting the full amount of its damages from the issuing bank. Although there is no bankruptcy court authority that has addressed this issue, case law in analogous situations seemingly supports this conclusion. For example, courts have found that a nondebtor guarantor cannot assert the cap to avoid its liability for the debtor/tenant’s rejection of a lease.⁸¹ Likewise, at least one court has found that the cap for lease damages under the Financial Institutions

78. See *Kellogg v. Blue Quail Energy, Inc.* (*In re Compton Corp.*), 831 F.2d 586, 589-90 (5th Cir. 1987).

79. *Id.* at 590.

80. Although preferential transfers are not the subject of this article, landlords need to be cautious concerning preferential transfer issues. If the letter of credit is being issued for an existing lease, rather than contemporaneously with a new lease, preferential transfer issues are raised.

81. See generally *Kopolow v. P.M. Holding Corp.* (*In re Modern Textile, Inc.*), 900 F.2d 1184 (8th Cir. 1990) (holding that the trustee’s rejection of the sublease did not discharge the guaranties); *Bel-Ken Assoc. v. Clark*, 83 B.R. 357 (D. Md. 1988) (holding that a statutory limitation on a landlord’s claim did not limit liability of third party guarantors after the bankruptcy trustee rejected the lease).

Reform, Recovery, and Enforcement Act of 1989 (FIRREA),⁸² which is even more restrictive than § 502(b)(6), does not restrict a lessor from pursuing a letter of credit for the full amount owed even though it exceeds the FIRREA cap.⁸³ Finally, the California Supreme Court has concluded that the independence principle does not enjoin a lender from demanding payment on a letter of credit even though the lender's claim against its borrower has been barred by application of California antideficiency laws.⁸⁴ Because FIRREA and the California antideficiency laws create an artificial restriction on pursuing a claim similar to the cap under § 502(b)(6), it could be argued that this precedent allows a landlord to recover the full amount of its damages from the issuing bank, free from the restrictions of § 502(b)(6).

Nonetheless, this theory is not risk free. For example, the letter of credit independence principle protects only the distribution of proceeds under a letter of credit, not whether the landlord is rightfully entitled to payment. Thus, while the debtor may not be able to stop the landlord from seeking recourse against a letter of credit, the debtor may be able to sue the landlord to recover any payment in excess of the cap. Moreover, the issuing bank may assert that, pursuant to UCC section 5-117, upon payment of the letter of credit, it becomes subrogated to the rights of the tenant/debtor, including the right to seek recovery of any payment exceeding the bankruptcy cap under § 502(b)(6). Finally, while letters of credit have many of the same characteristics as guarantees, they are not guarantees and guarantee case law may be held not to apply. Unfortunately, there is presently no court precedent that resolves these issues and, therefore, the outcome cannot be assured.

At the very least, the landlord should ask the tenant to post an irrevocable standby letter of credit for the maximum amount the landlord could obtain under the § 502(b)(6) cap. This strategy is the safest because, as noted in Part III.B.3, § 502(b)(6) does not impair

82. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) (granting broad powers to the Federal Deposit Insurance Corporation and establishing the Resolution Trust Corporation to resolve failed savings institutions).

83. *See* F.D.I.C. v. U.S. Trust Co., 793 F. Supp. 368, 373 (D. Mass. 1992).

84. *See* W. Sec. Bank v. Super. Ct., 15 Cal. 4th 232, 933 P.2d 507, 62 Cal. Rptr. 2d 243 (1997).

the landlord's ability to collect its actual damages, up to the amount of the cap, from a security deposit. This independence principle in all likelihood can also be applied to lease bonds and certificates of deposits to the benefit of landlords.

3. Tenant's direct payment for tenant improvements and leasing commissions

As set forth above, the cap under § 502(b)(6) limits only the landlord's claim for rent due and owing under the terms of a lease. Section 502(b)(6) does not restrict a secured creditor from recovering the full amount of advances it made to the debtor. Given this dynamic, the lease could be structured in such a manner as to require the tenant to pay for all tenant improvements and leasing commissions and provide the tenant with a separate secured loan to fund this amount. Such debt would be reflected in a promissory note from the tenant to the landlord. By structuring the transaction in this manner, the landlord could avoid capitalizing the tenant improvements and leasing commission costs in the rent stream, and thereby avoid the cap for such costs. Such a loan structure may not be subject to bankruptcy and state law limitations on lease awards since it could be characterized as a secured creditor/debtor relationship as opposed to a landlord/tenant relationship. The structure would have to take into account the effect that the promissory note—which would now represent a portion of the traditional rent stream—might have upon the “cap rate” applied by a potential buyer of the office project.

To further secure its position, the landlord would require the tenant to obtain an irrevocable letter of credit to secure its performance under the terms of the loan. Use of the letter of credit gives the landlord the additional benefit of the independence principle.

Nevertheless, a bankruptcy court could collapse this transaction. The term “rent reserved” refers to the tenant's fixed and regular obligations relating to its use and occupation of the property. A bankruptcy court could use § 502(b)(6) to cap the loan for tenant improvements under the theory that the loan payment, in reality, reflects payments by the tenant for its use and occupation of the

property. Unfortunately, no bankruptcy courts have resolved or decided this issue.⁸⁵

4. Payment of advance rent through an irrevocable letter of credit

Many landlords have sought to secure lease obligations through the receipt of large amounts of prepaid rent from tenants. Section 502(b)(6) could also arguably be avoided through the collection of advance rent or other fees under the lease. In theory, advance rent would be collected and applied prior to the bankruptcy and termination of the lease and, therefore, would not be included in the calculation of the cap. Once again, however, this strategy has not been tested in the courts. Moreover, of each of the foregoing strategies, this strategy may be the easiest to attack in court for several reasons.

First, the court could simply construe advance rent as a security deposit. As noted above, to the extent that a cash security deposit exceeds the cap, the excess security deposit must be refunded to the debtor.

Second, an argument could be constructed that acceptance of a large amount of advance rent constitutes a fraudulent conveyance. Under fraudulent conveyance laws, a debtor can avoid any payment or transfer of property made while the debtor was insolvent, or which effectively rendered the debtor insolvent, that is not supported by reasonably equivalent consideration. Assuming that the tenant is insolvent or is rendered insolvent, the payment of advance rent could be construed as a fraudulent conveyance. The tenant is arguably paying advance rent for amounts that it would not be obligated to pay if it rejects the lease in bankruptcy. Nevertheless, because the tenant is in fact getting the right to occupy the property at a future date for no additional consideration, a reasonably equivalent value should exist.

85. Landlords need to be cautious about the effect of this structure on a landlord's ability to evict the tenant in the event of lease default. Tenants may argue that the landlord may only evict them for nonpayment of rent due under the lease, not failure to make loan payments. While a landlord may mitigate against the argument through a cross-default clause, a cross-default clause only strengthens the tenant's argument that § 502(b)(6) should cap the damages for breach of the loan agreement.

Because of these risks, the landlord should not accept a cash payment for advance rent. Instead, in order to gain the additional benefit of the letter of credit independence principle, the advance rent should be paid to the landlord through the tenant's delivery of an irrevocable letter of credit.

5. Issues relating to letters of credit that are not renewed

When a tenant is not in bankruptcy, but allows a letter of credit to lapse, and the landlord receives a notice of the impending lapse from the letter of credit bank, the landlord is faced with an interesting conflict. If the landlord draws upon the letter of credit and turns the same into a cash security deposit, upon a tenant's bankruptcy, the tenant may argue that the cash is part of the tenant's estate and, therefore, is subject to the automatic stay. This could create serious timing problems for the landlord as previously discussed in Part II.B.2. If the landlord does not draw, the letter of credit will lapse, and landlord's security will evaporate.

In larger letter of credit transactions, the landlord can eliminate the possibility of this dilemma, by proceeding as follows. The landlord should provide for the opening of an escrow/bank account at a financial institution. The landlord would have a security interest in the account, and the account would allow for the payment of sums only upon the dual signature of both the landlord and tenant. When the letter of credit is lapsing, the landlord would direct the proceeds to be deposited into the account. If the landlord needed access to the security deposit and the tenant refused, the landlord would foreclose its security interest. In the event of a bankruptcy, the landlord would be a secured creditor. This approach could significantly improve the speed at which the landlord retrieves a security deposit that a tenant is entitled to receive in bankruptcy court. However, it would need to be emphasized in the documentation that the letter of credit proceeds are the property of the landlord, which is most likely the case as set forth in Part III.B.2, and that the security interest is only an additional safety mechanism. To avoid having to create such an escrow/bank account with each lease transaction, especially when such an account may never be used, the landlord should negotiate the terms of the escrow agreement in connection with the lease execution, but not sign the document at that time. Also, at lease execution, the landlord would receive from the tenant an executed

irrevocable power of attorney that could be used during the lease term to create the escrow/bank account when needed.⁸⁶

6. Lender issues relating to credit enhancement

In connection with a substantial letter of credit, some lenders require that they have a perfected security interest in the letter of credit. This requires, among other things, that they physically possess such a letter of credit and that it be issued in their name.⁸⁷ This creates significant problems for the landlord since the landlord is the party with the direct contractual relationship with the tenant relating to the letter of credit, and the landlord is extremely interested in the proper and timely use of the credit enhancement. The landlord's issues are generally as follows:

- The lender might misuse the letter of credit in violation of the lease document, thereby creating liability for the landlord.
- The lender may fail to cause a timely draw upon the letter of credit when the tenant fails to renew the letter of credit, and the letter of credit would lapse.
- The lender may refuse to allow a draw upon the letter of credit when the landlord deems it necessary to cure a tenant default, either due to the ineptness or uncooperative nature of the lender.

Such landlord concerns might be solved in the following compromising manner. The landlord would hold the letter of credit in its name until such time as a default under the loan documents occurred. Upon a loan default, the landlord would give possession of the letter of credit to the lender, but not transfer the letter of credit to the lender. When a draw was necessary due to a tenant default, including the failure to renew the letter of credit, the lender would cooperate with the landlord to allow the landlord to achieve the draw. The amount necessary to cure a tenant default could then be given to the landlord or used to cure a loan default, and any additional unused proceeds could be put in an escrow/bank account in which the lender had a security interest. This approach, with greater details and

86. See *infra* Attachments Numbers Four and Five for a model escrow agreement (labeled as a "Pledge and Security Agreement") and power of attorney, respectively, from a landlord's perspective.

87. See Norris, *supra* note 17, at 3-5.

caveats, might work for both the landlord and the lender. This would be true even though neither party gets everything they want. The lender would not have a perfected interest in the letter of credit, and the landlord would still be subject to the lender's failure to cooperate to make draws upon the letter of credit. However, it is probably an acceptable compromise position for a lender that has otherwise comfortably underwritten the loan it is making to the landlord.

B. Financial Problems—Predefault

Once a landlord has reason to believe a tenant's financial situation is questionable, the following steps should be taken.

- The landlord needs to confirm that the credit enhancement is available in the event of a tenant default, therefore, the landlord must ensure that the credit enhancement is in good standing. Unfortunately, many landlords have allowed L-Cs to expire, either on their own terms or due to a failure to respond to a notice of expiration. If applicable, the landlord should amend the notice block on the credit enhancement to ensure that several designated persons actually receive notice if the tenant fails to renew the credit enhancement. Such an amendment only requires that the beneficiary complete a simple form, which the issuer of the credit enhancement can provide, and does not require any action from the tenant, even if the issuer claims otherwise.
- The landlord then needs to set up a monitoring system in anticipation of a tenant default. Therefore, the landlord must ensure all tenant checks are mailed to an actual person instead of a lock box so that (1) the landlord will immediately know if a financial default occurs, (2) the tenant's payments can be quickly tracked, which is necessary should the landlord decide to bring an unlawful detainer against the tenant,⁸⁸ and (3) the tenant is not able to cure a monetary default

88. An unlawful detainer is a legal action brought by a landlord in order to regain possession of the premises. *See* BARRON'S LAW DICTIONARY 535 (4th ed. 1996).

without the landlord's knowledge, since a landlord may prefer to gain possession of the premises. If required, the landlord should provide the tenant with a Change of Address Notice in accordance with the notice terms of the lease.

- The landlord must refrain from interfering with any tenant relationship that could potentially result in an assignment or sublease of the premises. In other words, a landlord cannot try to discourage any potential subtenant from entering into an agreement with a troubled tenant. Although a landlord's natural tendency may be to warn the potential subtenant of the tenant's questionable financial condition and possible pending lease termination, such action may result in liability under several causes of action, including tortious interference with contractual relations. A landlord may, however, inform the potential subtenant that the landlord will review the documents per the letter of the lease. If a sublease is not possible, a direct lease may be more practical, especially if the sublease fails because it does not meet the potential subtenant's requirements—for example, if the remaining lease term is not long enough.
- If allowed by the lease, the landlord should consider setting up a pledge account.⁸⁹ A lease can be structured so that the landlord can unilaterally set up a pledge account.
- If applicable, the landlord should monitor the rating of the financial institution that provides the credit enhancement.⁹⁰ The greater the amount of credit enhancement provided for a troubled tenant, or the greater the total aggregate amount of credit enhancement a landlord has from a single financial institution, or the more questionable the economic stability of a financial institution, the closer the landlord must watch its rating.⁹¹

89. Pledge Accounts are discussed in Part V.A.5.

90. *See supra* Part II.A.2.

91. *See supra* note 20 and accompanying text.

C. Postdefault—Prebankruptcy

Once a tenant has defaulted, the landlord should remember its two main goals: (1) liquidate and collect the tenant's lease credit enhancement, and (2) regain possession of the premises as quickly as possible. In order to accomplish its goals, the landlord should take the following steps:

- The landlord should declare the tenant in default immediately. The landlord must ensure that the notice of default is sent in accordance with the terms of the lease and should also add any applicable late charge and interest to the amount due.
- If provided for in the sublease or the landlord's consent to sublease, the landlord should immediately inform all subtenants, if any, to pay the landlord directly. NOTE: If necessary, the landlord's sublease consent form template should be modified to provide for this contingency.
- The landlord should bring an unlawful detainer action in order to dispossess the tenant of the premises. Such action for unlawful detainer must be filed in accordance with applicable state law. For example, California Code of Civil Procedure section 1161 provides that a tenant is guilty of unlawful detainer "[w]hen he or she continues in possession . . . without the permission of his or her landlord . . . after default in the payment of rent, pursuant to the lease . . . and three days' notice, in writing, requiring its payment, stating the amount which is due . . . shall have been served upon him or her . . ." ⁹² Savvy landlords will ensure that any notice period required pursuant to the terms of the lease is in lieu of, and not in addition to, any notice period required by law. ⁹³ The action of filing an unlawful detainer should be weighed against whether it will force a tenant into filing bankruptcy. Although unlikely, this is possible and should be considered.

92. CAL. CIV. PROC. CODE § 1161(2) (West 2002).

93. See CAL. CIV. PROC. CODE § 1161 (West 2002) (requiring a three-day notice period).

- The landlord must determine how much of the credit enhancement to draw and whether to put all or a portion of the excess amount into a pledge account, if any. The draw process itself is rather complicated, and, therefore, the landlord must proceed cautiously to ensure that it is done correctly. The determination of how much of the credit enhancement to draw is based on the landlord's anticipated damages as set forth under the lease and state law. This too can be complicated, and, to reduce the likelihood of a counterclaim by the tenant, should be done cautiously.
- The landlord must ensure that all actions are performed with a view towards bankruptcy implications. In other words, if a tenant later declares bankruptcy, a trustee will be appointed over the bankruptcy estate. The trustee will have control over all assets in the estate, including the leasehold. In addition, the trustee has the power to avoid some of the tenant's past transactions, e.g., if such transactions were based on either a preference (benefits one creditor at the expense of another) or due to a fraudulent conveyance.
- The landlord must review the lease to determine the impact of a tenant default on the rights and obligations of the parties (e.g., the landlord's right to cease funding of the tenant improvement allowance, the tenant's inability to exercise certain options while in default, etc.).

VI. CONCLUSION

High-Tech tenants are not likely to go away and, as a result, will continue to need office space in the future. Landlords want to lease office space to High-Tech tenants since doing so increases the number of potential tenants for their office space. A problem arises, however, because the significant rise in High-Tech bankruptcies has caused landlords to question whether their bargained-for credit enhancement would survive the bankruptcy process. Accordingly, many landlords now question whether it is prudent in the future to enter into a lease with a High-Tech tenant—no matter how well-secured such a lease is by credit enhancement. The changes to the

Code that are recommended are intended to ensure that landlords do not form deep-seated policies adverse to High-Tech tenants. By allowing landlords to structure the credit enhancement provision of an office lease in a manner that is protected from a tenant bankruptcy, the Code will promote leasing to High-Tech tenants, which in turn benefits both the High-Tech tenants and the landlords.

ATTACHMENT NUMBER ONE**MODEL LEASE LETTER OF CREDIT
PROVISIONS****Letter of Credit.**

.1 *Delivery of Letter of Credit.* Tenant shall deliver to Landlord concurrent with Tenant's execution of this Lease, an unconditional, clean, irrevocable letter of credit (the "L-C") in the initial amount of \$ _____, which L-C shall be issued by a money-center bank (a bank which accepts deposits, maintains accounts, has a local _____ office which will negotiate a letter of credit, and whose deposits are insured by the FDIC) reasonably acceptable to Landlord, and which L-C shall be in a form and content as attached hereto as **Schedule 1**. Tenant shall pay all expenses, points, and/or fees incurred by Tenant in obtaining the L-C.

.2 *Application of Letter of Credit.* The L-C shall be held by Landlord as security for the faithful performance by Tenant of all the terms, covenants, and conditions of this Lease to be kept and performed by Tenant during the Lease Term. The L-C shall not be mortgaged, assigned, or encumbered in any manner whatsoever by Tenant without the prior written consent of Landlord. If Tenant defaults with respect to any provisions of this Lease, including, but not limited to, the provisions relating to the payment of Rent, or if Tenant fails to renew the L-C at least thirty (30) days before its expiration, Landlord may, but shall not be required to, draw upon all or any portion of the L-C (A) for payment of any Rent or any other sum in default, (B) for the payment of any amount that Landlord may reasonably spend or may become obligated to spend by reason of Tenant's default, (C) to compensate Landlord for any other loss or damage that Landlord may suffer by reason of Tenant's default, or (D) to apply the proceeds as set forth in items (A) through (C) and cause the remainder to become an "L-C Security Deposit," as defined below. The use, application, or retention of the L-C, or any portion thereof, by Landlord shall not prevent Landlord from exercising any other right or remedy provided by this Lease or by

law, it being intended that Landlord shall not first be required to proceed against the L-C and shall not operate as a limitation on any recovery to which Landlord may otherwise be entitled. Any amount of the L-C which is drawn upon by Landlord, but is not used or applied by Landlord, shall be held by Landlord and deemed a security deposit (the "**L-C Security Deposit**"). If any portion of the L-C is drawn upon, Tenant shall, within five (5) days after written demand therefor, either (i) deposit cash with Landlord (which cash shall be applied by Landlord to the L-C Security Deposit) in an amount sufficient to cause the sum of the L-C Security Deposit and the amount of the remaining L-C to be equivalent to the amount of the L-C then required under this Lease or (ii) reinstate the L-C to the amount then required under this Lease, and if any portion of the L-C Security Deposit is used or applied, Tenant shall, within five (5) days after written demand therefor, deposit cash with Landlord (which cash shall be applied by Landlord to the L-C Security Deposit) in an amount sufficient to restore the L-C Security Deposit to the amount then required under this Lease, and Tenant's failure to do so shall be a default under this Lease. Tenant acknowledges that Landlord has the right to transfer or mortgage its interest in the Project and in this Lease and Tenant agrees that in the event of any such transfer or mortgage, Landlord shall have the right to transfer or assign the L-C Security Deposit and/or the L-C to the transferee or mortgagee, and in the event of such transfer, Tenant shall look solely to such transferee or mortgagee for the return of the L-C Security Deposit and/or the L-C. Tenant shall, within five (5) days of request by Landlord, execute such further instruments or assurances as Landlord may reasonably deem necessary to evidence or confirm Landlord's transfer or assignment of the L-C Security Deposit and/or the L-C to such transferee or mortgagee. If Tenant has not been in default under this Lease, the amount of the L-C shall, commencing _____, be reduced by an amount equal to \$_____. If Tenant shall fully and faithfully perform every provision of this Lease to be performed by it, the L-C Security Deposit and/or the L-C, or any balance thereof, shall be returned to Tenant within thirty (30) days following the expiration of the Lease Term.

Schedule 1

Form of Letter of Credit

(Letterhead of a Money Center Bank Acceptable to
the Landlord)

_____, 200__

Gentlemen:

We hereby establish our Irrevocable Letter of Credit and authorize you to draw on us at sight for the account of _____, a _____, the aggregate amount of _____ Dollars (\$_____).

Funds under this Letter of Credit are available to the beneficiary hereof as follows:

Any or all of the sums hereunder may be drawn down at any time and from time to time from and after the date hereof by _____ (“Beneficiary”) when accompanied by this Letter of Credit and a written statement signed by _____, certifying that such moneys are due and owing to Beneficiary, together with a certificate of incumbency executed by _____ certifying the position and signature of the officer signing the statement, and a sight draft executed and endorsed by _____, as a _____ of Beneficiary.

This Letter of Credit is transferable in its entirety without charge to Beneficiary. Should a transfer be desired, such transfer will be subject to the return to us of this advice, together with written instructions.

The amount of each draft must be endorsed on the reverse hereof by the negotiating bank. We hereby agree that this Letter of Credit shall be duly honored upon presentation and delivery of the certification specified above.

This Letter of Credit shall expire on _____, 200__.

Notwithstanding the above expiration date of this Letter of Credit, the term of this Letter of Credit shall be automatically renewed for successive, additional one (1) year periods unless, at least thirty (30) days prior to any such date of expiration, the undersigned shall give written notice to Holder, by certified mail, return receipt requested and at the address set forth above or at such other address as may be given to the undersigned by Holder, that this Letter of Credit will not be renewed.

This Letter of Credit is governed by the Uniform Customs and Practice for Documentary Credits (1993 Revision), International Chamber of Commerce Publication 500.

Very truly yours,
(Name of Issuing Bank)

By: _____

ATTACHMENT NUMBER TWO

MODEL LEASE/SURETY BOND PROVISION

____.1 Lease Bond. Concurrent with Tenant's execution of this Lease, Tenant shall deliver to Landlord a surety bond (as amended, renewed or replaced from time to time, the "Bond"), in the form attached to this Lease as **Schedule 1**, in the amount of _____ (\$ _____), and having an expiration date no earlier than _____.

____.2 Bond Requirements. The Bond (i) shall be issued by a surety located in _____, California, reasonably satisfactory to Landlord and rated at least "A-__" in the then most current issue of Best's Insurance Reports or an equivalent rating service reasonably selected by Landlord, and (ii) shall indicate thereon that the Bond is transferable in its entirety by Landlord, as obligee, and that the surety shall reissue such Bond, naming such transferee as the obligee, upon (A) receipt by the surety of written notice of a transfer of Landlord's interest in the Lease, and (B) presentation to the surety of the original Bond. Tenant shall be responsible for all expenses, points and/or fees incurred by Tenant in obtaining, maintaining and extending the Bonds. If Landlord sells its interest in the Building during the Lease Term, and if Landlord deposits with the purchaser thereof a Bond or any proceeds thereof, then such purchaser shall have all the benefits under the Bond and Landlord thereupon shall be discharged from any further liability to Tenant with respect to such Bond and said proceeds.

____.3 Claims Under the Surety Bonds. In the event of a default by Tenant under this Lease, after expiration of applicable cure periods, Landlord shall have the right (but not the obligation) to make a claim upon all or any portion of the Bond and Tenant shall, upon demand therefor, restore the Bond to its original amount. Any amounts so received may be utilized by Landlord to cure such default or may be used by Landlord to compensate Landlord for any loss or damage which Landlord may suffer by reason of Tenant's default or may be held by Landlord as security for the obligations of Tenant under this Lease. Tenant shall not be entitled to any interest

on any such funds so held by Landlord. If it is determined that a claim was not permitted under this Lease or the amount so received exceeds the amount to which Landlord is entitled under this Lease, then Landlord shall promptly repay to Tenant the unpermitted amount.

Schedule 1

Form of Lease Guarantee Bond

KNOW ALL MEN BY THESE PRESENT, that _____, a _____, as Principal, and _____, as Surety, are hereby firmly bound unto _____, a _____, (hereinafter called Obligee), in the aggregate penal sum of _____ Dollars (\$_____), for payment of which we hereby bind ourselves, and our successors, assigns, and trustees, jointly and severally, by these presents.

WHEREAS, the Principal and _____ have entered into a lease agreement (hereinafter the "Lease") dated _____, and in consideration of the rents, covenants, and agreements contained herein, to be paid and performed by the said Principal, _____ has leased unto said Principal the certain premises located at _____, and more fully described in the Lease, for a term of _____ (____) years from the Lease Commencement Date as defined in the Lease.

NOW, THEREFORE, the condition of this obligation is such that if the Principal shall well and truly perform all obligations according to the terms of the Lease, then this obligation shall be void, otherwise to remain in full force and effect.

Any and all of the sums hereunder (up to the aggregate penal sum of _____ Dollars (\$_____)), may be drawn down at any time and from time to time from and after the date hereof by Obligee when accompanied by this original Bond and a written statement signed by an authorized signatory of Obligee (which shall include the exercise of a power of attorney from any Obligee), certifying that such moneys are due and owing to Obligee as a result of a default by Principal, after expiration of any applicable cure period, with respect to any provision of the Lease, together with a notarized certification by any such individuals representing that

such individual is authorized by Obligee to take such action on behalf of Obligee. The sums drawn by Obligee under this Bond shall be payable upon within thirty (30) days of written demand to Obligee without necessity of prior notice of defaults by the Principal or action on the Bond.

Upon receipt from Obligee of a certification of amounts owing by Principal, Surety shall be unconditionally obligated to pay such amounts regardless of any defenses of Principal (including without limitation defenses which Principal may have for failure of consideration, statute of limitations, accord and satisfaction, discharge, or failure to mitigate). However, provided that Obligee's certified demand is timely paid by Surety, neither the provisions of this Bond nor the payments by Surety of any amount hereunder shall preclude Surety or Principal from later raising such defenses as theories of recovery.

This Bond may be transferable in its entirety by Obligee at no cost. Upon Surety receiving notice of Obligee's transfer of its interest in the Lease and upon presentation to the Surety of the original Bond, surety will reissue the Bond naming such transferee as the new Obligee hereunder.

Surety hereby waives notice of acceptance of this Bond and notice of the incurring of any indebtedness guaranteed thereby. Surety hereby waives any right of consent and defense to the enforceability of this Bond under California Civil Code section 2819. Surety hereby agrees that Obligee and Principal may alter, modify, increase, reduce, compromise, renew, extend, and/or refinance any obligations under the Lease without first obtaining the consent of (or providing notice to) Surety and the occurrence of the foregoing shall not constitute a defense to the enforceability of this Bond or discharge Surety from liability hereunder, provided that the terms and conditions and penal sum of this Bond remain unchanged. The foregoing provision shall apply to this Bond notwithstanding any contrary provision of applicable law. Surety hereby waives any defense to Surety's obligations under this Bond on account of Obligee's release, waiver, substitution, failure to perfect security interest in, and/or foreclosure of any collateral pledged by Principal.

Surety hereby waives the right to assert any defense to the enforcement and Obligee's draw on this Bond which may be provided under California Civil Code sections 2808, 2809, 2810, 2819, 2845, 2849, 2850 and 2855.

Obligee may enforce and draw on this Bond separately from the underlying obligations of Principal and any collateral therefore, and need not proceed first against the Principal or any collateral.

In the event Surety refuses to unconditionally and immediately honor a draw request by Obligee, then Obligee shall be entitled to recover all attorneys' fees and costs incurred in pursuit of such claim, whether or not legal action is commenced, and whether or not such legal action is pursued to judgment.

It is understood that this Bond is continuous, and may not be canceled during the term of the Lease, provided that Landlord shall either have tendered this Bond for payment in accordance with the terms hereof or this Bond shall be cancelled and terminated on the date which is sixty (60) days following the expiration or earlier termination of the Lease.

Signed and Sealed: _____

ATTACHMENT NUMBER THREE

FORM OF CERTIFICATE OF DEPOSIT

(Letterhead of _____ Bank)

_____	PAYMENT BOND CERTIFICATE Automatic Renewal, Nonnegotiable	Certificate Serial Number
Office of Account: _____ Account Number: _____ Amount Deposited \$ _____ On _____, _____ Dollars were deposited for _____ months by _____ (“Depositor”) and is payable to _____ on _____, _____ (the “Maturity Date”), upon presentation of this Certificate, properly endorsed by _____. This deposit will earn interest at the rate of _____ compounded daily using a 365-day year, for an annual percentage yield of _____. Interest will be paid to the Depositor _____. If this Certificate is not presented for payment on the account’s Maturity Date or within _____ days after that date, the deposit will be renewed for a like term at the interest rate in effect on the account’s Maturity Date. This Certificate is fully transferable by holder. This Certificate shall not be altered, amended, or terminated without the consent of _____. This Certificate shall be automatically renewed throughout the Lease Term without action by _____. This Certificate shall be transferable by _____ without the imposition of a transfer fee. If all or any part of this deposit is withdrawn before the account’s original or subsequent maturity date, the amount withdrawn may be subject to an early withdrawal or compensating fee.		
_____ AUTHORIZED SIGNATURE		

ATTACHMENT NUMBER FOUR

MODEL FORM OF PLEDGE AND SECURITY AGREEMENT

THIS PLEDGE AND SECURITY AGREEMENT (the “**Agreement**”), is made and entered into as of the ____ day of _____, by and between _____, a _____ (the “**Pledgor**”) and _____, a _____ (the “**Pledgee**”).

RECITALS

A. Concurrently herewith, the Pledgor and the Pledgee have entered into that certain Lease dated as of _____ (the “**Lease**”), concerning the lease by the Pledgee, as Landlord, to the Pledgor, as Tenant, of _____ (the “**Premises**”) located at _____ (the “**Building**”). The term of the Lease shall commence on the “Lease Commencement Date,” as defined in the Lease.

B. Pursuant to Sections _____ of the Lease, Pledgor has agreed to provide certain security (the “**Security**”) securing certain obligations of Pledgor under the Lease.

C. This Agreement is made pursuant to Sections _____ of the Lease to effect the establishment of a special “Collateral Account” (as defined below in Section 1) for the Security contemplated thereby. Upon certain events as described in the Lease, Pledgee shall deposit certain funds in such Collateral Account (the “**Deposited Funds**”). The Deposited Funds shall serve as a source of funds for satisfaction of Pledgor’s monetary obligations under the Lease.

D. The parties now desire to enter into this Agreement in accordance with the terms and conditions set forth below. All capitalized terms not otherwise defined herein shall have the same meanings as set forth in the Lease.

Account as allowed under the Uniform Commercial Code with respect to the perfection of a security interest upon such Collateral and Collateral Account.

1.3 Registration, Withdrawal Authority. Until the occurrence of a "Default," as that term is defined in the Lease, and the Pledgor's receipt of a written demand from the Pledgee, the Collateral Account shall remain registered in the name of the Pledgor. Upon the occurrence of a Default and receipt of a written demand from the Pledgee, Pledgor shall cause the Collateral Account and the Deposited Funds, or such part thereof as shall be determined by the Pledgee, to be transferred, registered, or otherwise put into the name of the Pledgee, but only to the extent, and in an amount sufficient to cure the Default and to pay the Pledgee the amount of damages sustained by the Pledgee as of such date.

2. Obligations. This Agreement is given to secure payment of Rent (consisting of both "Base Rent" and "Additional Rent," as those terms are set forth in _____ and _____ of the Lease, respectively) pursuant to the terms of the Lease and other obligations of Pledgor under the Lease and under any ancillary documents executed by Pledgor pursuant to the terms of the Lease (collectively, the "Obligations").

3. Authorization and Enforcement of Obligations. Each party to this Agreement represents and warrants to the other that: (i) it has the power and authority to enter into, and to perform the transactions contemplated by, this Agreement and has taken all necessary action to authorize the execution, delivery, and performance of this Agreement and the transactions contemplated herein; (ii) no consent or authorization of, filing with, or act by or in respect of, any governmental entity having jurisdiction over such party is required in connection with the pledge hereunder or with the execution, delivery, performance, validity, or enforceability of this Agreement, and (iii) this Agreement, when duly executed and delivered by such party, shall constitute the legal, valid, and binding obligation of such party, enforceable against such party in accordance with its terms.

AGREEMENT

NOW, THEREFORE, in consideration of the covenants contained herein, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows.

1. Pledged Deposit.

1.1 Deposit. In accordance with the terms of the Lease, Pledgee shall deposit the Deposited Funds in that certain "Collateral Account"

1.2 Collateral Account. Pledgor hereby pledges, grants a security interest in, assigns, transfers, and delivers to the Pledgee, as collateral security for the payment when due and performance in full by Pledgor of the Obligations (as defined in Section 2 below), the following (referred to herein collectively as the "Collateral"):

(i) that certain deposit account no. _____ located at _____ or its legal successor (the "Bank"), _____ Branch, _____, California (the "Collateral Account"),

(ii) all Deposited Funds on deposit in the Collateral Account now and at any time after the date of this Agreement, (iii) all interest accruing thereon, (iv) all renewals and replacements thereof (whether or not any such renewal or replacement is evidenced by a certificate or other evidence of deposit), (v) any and all certificates of deposit or other instruments that may constitute a part of or an investment of funds in, or that may replace all of or part of, the Collateral Account, and (vi) all proceeds of any of the foregoing. At all times hereunder, except to the extent of any realization by the Pledgee upon the Collateral pursuant to Section 5 hereof, all amounts in the Collateral Account shall be invested either in the Banks' money market fund or in certificates of deposit issued by the Bank having maturities of thirty (30) days or less, as the Pledgee may designate from time to time. Pledgor and Pledgee shall execute and deliver to the Bank a Notice of Security Interest in Deposit Account in the form attached hereto as **Schedule 1**. Pledgee shall have the right to perform all such other acts with respect to such Collateral and Collateral

4. *Title.* The Pledgor represents and warrants to the Pledgee that the Pledgor is the lawful owner of all rights and interest in the Collateral Account, free of all claims and liens other than the security interest granted in this Agreement to the Pledgee, with full rights to assign, transfer, and pledge the Collateral Account to the Pledgee. The Pledgor will not voluntarily create, incur, or permit to exist any pledge, lien, mortgage, hypothecation, security interest, charge, option, or any other encumbrance with respect to the Collateral Account, or any interest therein, except for the security interest provided for by this Agreement.

5. *Remedies.* Upon the occurrence and during the continuance of any Default, the Pledgee shall have all rights and remedies provided by law, the Lease, and this Agreement, including, without limitation, all of the rights and remedies of a secured party under the California Commercial Code. The Pledgor hereby authorizes the Pledgee, upon the occurrence of a Default, to take whatever actions may be necessary to realize upon the Collateral Account and to apply the proceeds realized in accordance with the Lease. The Pledgor expressly authorizes such action by the Pledgee in advance of and to the exclusion of any realization upon any other collateral securing any indebtedness of the Pledgor to the Pledgee, and hereby waives as to the Pledgee any right of subrogation or marshalling of such other collateral for the Obligations. Notwithstanding the foregoing, subject to the terms of the Lease the Pledgee shall not be obligated to take action to realize upon the Collateral Account prior to exercising any other rights or remedies it may have as provided by law, the Lease, or this Agreement.

6. *Further Acts and Assurances.* Each party hereto, upon request of the other party, agrees to do such further acts, and to execute, acknowledge, endorse, and deliver such further instruments and agreements (specifically including, but not limited to UCC-1s), that such other party may at any time and from time to time reasonably request in connection with the administration or enforcement of this Agreement, or related to the Collateral or any part thereof, or in order to further assure and confirm to such other party its rights, powers, and remedies hereunder.

7. No Waiver. No forbearance, failure, or delay by the Pledgee in the exercise of any right or remedy hereunder shall operate as a waiver thereof and no single or partial exercise by the Pledgee of any right or remedy shall preclude any other or further exercise thereof or the exercise of any other right or remedy. All rights, powers, and privileges of the Pledgee under this Agreement and the Lease shall be cumulative.

8. Notices. All notices, requests, demands, or other communications given pursuant to this Agreement shall be deemed to have been duly given and made when sent by certified mail, return receipt requested. Any such notice, request, demand, or communication shall be delivered or addressed to a party at its address set forth in the Lease, or such other address as any party hereby may designate by written notice to the other party.

9. Termination. This Agreement shall terminate on the date which is thirty (30) days after the expiration or earlier termination of the Lease and any remaining Deposited Funds and any interest accrued thereon shall be refunded to Pledgor.

10. Amendments, Conflicts. The provision of this Agreement may not be waived, altered, amended, or repealed in whole or in part except by the express written agreement of Pledgor and Pledgee. To the extent that any provision of this Agreement conflicts with any provision of the Lease, the Lease shall control on the point of conflict.

11. Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of California.

IN WITNESS WHEREOF, the Pledgor and the Pledgee have caused this Agreement to be executed as of the date first above written.

“Pledgor”:

_____,
a _____,

By: _____

Its: _____

By: _____

Its: _____

“Pledgee”:

_____,
a _____,

By: _____

Its: _____

By: _____

Its: _____

Schedule 1

(Form of Notice of Security Interest in Deposit Account)

NOTICE IS HEREBY GIVEN that _____, a _____ (the “**Pledgee**”), pursuant to that certain Pledge and Security Agreement (Security Deposit), dated as of _____, _____, executed by _____, a _____ (the “**Pledgor**”), holds a security interest in Account No. _____ registered in the name of the Pledgor, with _____ (the “**Bank**”), at its _____ Branch, located _____ at _____, _____, California _____, and all replacements, renewals and proceeds thereof (the “**Collateral Account**”).

This Notice of Security Interest in Deposit Account (the “**Notice**”) shall remain in full force and effect until amended or revoked by written instrument executed by the Pledgor and the Pledgee and may not otherwise be amended or revoked. The Bank is hereby irrevocably authorized and directed to honor withdrawals of funds from the Collateral Account at any time only upon the joint signatures of one (1) representative of the Pledgor and one (1) representative of the Pledgee, unless otherwise directed pursuant to court order. The identity of the particular representatives of the Pledgor and the Pledgee is subject to change and shall be designated from time to time by the Pledgor or the Pledgee, as applicable, to the Bank.

This Notice is given pursuant to California Commercial Code section 9302(g)(ii) in order to perfect a security interest in said deposit account.

DATED: _____, _____

“Pledgor”

_____,
a _____

By: _____

Its: _____

By: _____

Its: _____

“Pledgee”

_____,
a _____

By: _____

Its: _____

By: _____

Its: _____

The undersigned acknowledges receipt of, and agrees to be bound by the terms of, the foregoing Notice.

_____,
a _____

By: _____

Name: _____

Title: _____

ATTACHMENT NUMBER FIVE

MODEL SPECIAL POWER OF ATTORNEY

STATE OF CALIFORNIA)
) ss.
COUNTY OF _____)

KNOW ALL MEN BY THESE PRESENT: That the undersigned, _____, a _____ (the "Company"), does hereby make, constitute and appoint _____, a _____ ("Landlord") its true and lawful special attorney-in-fact for it and in its name, place, and stead, and for its use and benefit, for the purpose of establishing on its behalf one or more accounts (hereafter the "Bank Accounts") at one or more banks or other financial institutions and to execute all documents and instruments required in connection with (i) the establishment and maintenance of the Pledged Account(s) referenced in _____ of that certain Lease dated _____, by and between the Company and Landlord including the execution and filing of any UCC-1 routed to such Bank Account and the Notice of Security Interest in Deposit Accounting attached as Schedule 1 to Exhibit __ to the Lease and including the execution of the "Pledge and Security Agreement" attached as Exhibit __ to the Lease, and (ii) any other business of the Company regarding the Bank Accounts, including, but not limited to, the execution of signature cards.

THE UNDERSIGNED gives and grants to its special attorney-in-fact full power and authority to do and perform all and every act enumerated herein and things requisite or proper to be done in the exercise of any of the rights and powers herein granted, as fully to all intents and purposes as it might or could do if personally present, hereby ratifying and confirming all that its special attorney-in-fact shall lawfully do or cause to be done by virtue of the authority granted herein.

While this instrument is to be construed and interpreted as a special power of attorney, it is not to be construed or interpreted as

limiting or restricting the special powers granted herein to the special attorney-in-fact.

The rights, powers and authority of the special attorney-in-fact to exercise any and all of the rights and powers herein granted shall commence and be in full force and effect immediately and shall terminate on the Lease Expiration Date, or such later date as such Pledged Account(s) remain in existence.

IN WITNESS WHEREOF, I have here unto set my hand this ___ day of _____, 200__.

a _____

By: _____

Its: _____

By: _____

Its: _____

[Notary Blocks]

