

Protect Yourself if Your E-Commerce Tenant Goes Bankrupt

As technology stocks swing wildly up and down, expect to see many e-commerce tenants—also known as Internet or “dot-com” companies—fail to survive the downturns and file for bankruptcy. Unfortunately, bankruptcy laws severely limit the amount of money you’re entitled to recover once your e-commerce tenant goes belly-up. For instance, you’ll be limited in the amount of rent that you can claim unless the e-commerce tenant comes out of the bankruptcy successfully and keeps your lease, says Michael P. Richman, a bankruptcy attorney in New York City. What’s worse, the e-commerce tenant may not have enough money to cover even that limited amount after it pays off creditors with higher priorities, such as secured creditors, he says.

We’ll give you two strategies that may help you avoid the risk of losing money if an e-commerce tenant files for bankruptcy. Plus there’s Model Lease Language that you can add to the leases you negotiate with e-commerce tenants.

Bankruptcy Limitations

Under federal bankruptcy law, when a tenant files for bankruptcy, its bankruptcy trustee has the right to either assume or reject the tenant’s unexpired leases, depending on which is more advantageous to the tenant’s estate, says Richman. If the trustee assumes the lease, the tenant will continue to pay rent (and must also pay any overdue rent that accumulated before the bankruptcy), says Richman. But if the trustee rejects the lease, the tenant stops paying rent. All you can do then is make an unsecured claim for damages

that can’t exceed the greater of: 1) one year’s rent, or 2) 15 percent of the rent for the remaining lease term (not to exceed three years), he says.

These limits may hurt even more if you gave the tenant a tenant improvement allowance (TIA) and expected to get this money back through the rent you collect, Richman says. The one year/15 percent limitations still apply, he notes.

Two Protective Strategies

You can try to protect yourself from losses if the e-commerce tenant goes bankrupt by using one or both of the following strategies:

1) Make tenant pay tenant improvement costs.

Don’t give the e-commerce tenant a TIA. Instead, require it to pay for all of its tenant improvement costs, including soft costs—that is, the fees of engineers and architects, says California attorney Susan Fowler McNally. If you make the tenant pay for these costs, you’ll typically charge a lower rent. But you won’t have to worry about being out of pocket for the costs. You’ll find that many e-commerce tenants have a lot of cash on hand, from investments by venture capitalists, so they should be able to pay the tenant improvement costs, she adds.

The tenant improvement costs will typically include:

- Design, function, and maintenance costs of the improvements, plus engineering and architectural fees;

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ADJUST SUBLET SPACE THRESHOLD (continued from p. 1)

- Any cost increases that result from the improvements, such as additional costs due to work delays; and
- All costs necessary to increase the floor's load-bearing capacity to accommodate the tenant's use of the space.

To use this strategy, add the following language to your lease where you discuss tenant improvements.

Model Lease Language

Tenant shall cause all Tenant Improvements to be constructed in accordance with the Landlord Approved Plans at Tenant's sole cost and expense, which cost and expense shall include, without limitation:

- (i) except as specifically provided otherwise in the Lease, the cost of the design, function, and maintenance of all Tenant Improvements, including, without limitation, all engineering and architectural fees, whether generated by Tenant's or Landlord's engineer or architect;
- (ii) except as specifically provided otherwise in the lease, any increased cost in completing the Tenant Improvements; and
- (iii) all costs and expenses necessary to increase permitted structural floor loading in order to accommodate Tenant's Use.

2) Sign separate loan agreement. If the e-commerce tenant can't pay all of these improvement

costs, consider loaning it the amount it's short. Do this with a separate loan agreement, not under the lease, say McNally and Richman. If you put this arrangement in the lease, it will be subject to the bankruptcy law's limitations on rent.

In return for the loan, the e-commerce tenant should give you a promissory note that's secured by a letter of credit, says McNally. This will provide you with extra security, since you can still draw on a letter of credit if the tenant has filed for bankruptcy, she explains. In contrast, a cash security deposit can't be tapped until after the court lifts the bankruptcy stay, she says.

Will this strategy work? There's no assurance that a bankruptcy court won't rule that the loan repayments are really rent in disguise, warns Richman. In that case, you'll be stuck with the same bankruptcy limitations that apply to rent. But it's worth a try. ▲

Further reading: *CLLI*, March 2000, p. 1, "How to Cut Risks When Renting to E-Commerce Tenants."

CLLI Sources

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