

## Securing Lease Obligations - *Lease Guaranties, Letters of Credit and Other Credit Enhancements*

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### Part I. Introduction

One of the first issues a landlord's attorney should consider when drafting a lease is the creditworthiness of the proposed tenant. Although the issue is typically discussed at the business level and addressed in the letter of intent, if it is not so addressed, it is essential that the issue be raised with the client. An "empty shell" tenant which walks away from a lease does more damage than simply depriving the landlord of rent flow; the vacated space may require extensive cleaning and repairs, the building may be burdened with mechanics' liens, and the client may be left with nothing but a worthless indemnity to fall back on. If the proposed tenant does not have sufficient credit, a landlord may look to credit enhancement mechanisms to provide a source of funding for lease obligations that a proposed tenant does not perform. To the extent that the tenant has sufficient credit, no credit enhancement mechanisms will be required unless a landlord desires to protect itself with credit enhancement mechanisms during the limited period of time that a tenant is performing its build-out. This article will examine the three most common credit enhancements for lease obligations to be performed by a tenant: (i) cash, usually in the form of security deposits or prepaid rent, (ii) lease guaranties, and (iii) letters of credit, with an emphasis on non-bankruptcy issues.

1. The most basic form of due diligence a landlord can perform in determining whether or not credit enhancements are necessary, is to examine the financial statements of the proposed tenant. Such financial statements, whether obtained from the internet in the case of a public company, or directly from the tenant or its accountant, must be

carefully scrutinized to give the landlord comfort that the tenant has the resources to run its business, pay rent and satisfy all of the other lease obligations for the life of the lease. In the majority of cases, the financial statements are reviewed directly by the client's accounting department or outside accountants and not by its attorney.

2. Once the credit of the proposed tenant has been verified, it is imperative that the exact name and state of incorporation of the credit entity be given to the drafting attorney. Slight discrepancies in the name of the tenant may result in an empty shell tenant being on the lease. If the credit entity is "ABC Corp." and the tenant under the lease is "ABC Inc.", there is an argument that the credit tenant is not on the lease. Similarly, if the credit entity is "ABC Corp., a Delaware corporation" and the tenant under the lease is "ABC Corp., a New York corporation", the landlord may be out of luck. In a down market, a tenant may look through its portfolio of leases to find leases that it will be the easiest to terminate or walk away from, and a lease with an empty shell tenant with no security or guarantee will be the first choice.

3. In evaluating what credit enhancement mechanisms to demand, experience and record of success of the tenant in operating the type of store it intends to operate in the premises must be considered. Start-up companies will require more extensive security than companies with a proven track record. Given the high rate of initial business failures, if the client is leasing to a start-up retailer with no prior business experience, credit enhancements become critical. In determining the amount of security to require, consideration should be given to the

amount of time it will take to find a new tenant in the case of an eviction of the initial tenant and, optimally, the security should be sufficient to compensate the landlord for lost rent until rent commences under the new lease.

4. In addition to analyzing the credit and experience of the tenant, the viability of the business sector in which the tenant operates should be carefully considered. Common sense may lead one to conclude that there is not much up-side in certain products or businesses and in such cases one may ask for stronger security as a hedge against such a risk. For example, a landlord may be especially wary of credit issues when leasing to a video store given the state of video technology at this point in time. Keeping current with consumer tastes and business trends is critical in this regard.

5. Even if a tenant has strong credit and the business sector within which tenant intends to operate is promising, many landlords protect themselves against future downturns by requiring the tenant to make a net worth covenant in the lease, allowing the landlord to either terminate the lease, or require the tenant to post additional

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security, in the event that a tenant's net worth falls below an agreed threshold. Alternatively, such a termination option may be triggered if a tenant's gross sales do not exceed an agreed threshold. Needless to say, tenants strongly resist such clauses. More common is a requirement that tenant meet specified financial strength criteria or put up additional credit enhancement (security deposit, prepaid rent, guaranty or letter of credit) as a condition to exercising options to expand or renew, arguing that it would not be interested in doing a deal with a weak financial tenant so it should not be forced to extend the term or increase the space demised to a tenant in such a position.

Ultimately, the amount and type of credit enhancement mechanisms obtained will, like most other critical clauses in a lease, be a function of the bargaining power of the parties and market variables.

### Part II Cash-Security Deposits and Prepaid Rent

1. Both security deposits and prepaid rent are treated as part of the tenant's estate in the event of a tenant bankruptcy. *In re Mayan Networks Corporation*, 306 B.R. 295, 299 (9th Cir. 2004). Although prepaid rent is generally treated the same as a security deposit under both bankruptcy and state law, at least one bankruptcy court has held that prepaid rent cannot be applied towards the landlord's damages and must be returned to the tenant's bankruptcy estate. *In re Orangebrook Concessions, Inc.*, 47 B.R. 858 (S.D. Fla. 1985).

2. If the tenant goes into bankruptcy, the landlord cannot terminate the lease or apply the security deposit or prepaid rent against sums owed without first getting permission from the bankruptcy court (i.e., obtaining relief from the automatic stay). 11 U.S.C. § 362(a)(7)

3. Even if a tenant in bankruptcy rejects the lease, Bankruptcy Code Section 502(b)(6) limits the damages the landlord can recover from the tenant to the greater of: (i) one year's rent; or (ii) 15% of the rent owed for the balance (but not more than 3 years) of the term ("Cap"). The security deposit must be applied to the Cap. See *Oldden v. Tonto*

*Realty Corp.*, 143 F.2d 916, 921 (2nd Cir. 1944) and Legislative History of 11 U.S.C. § 502. If the amount of the security deposit and/or prepaid rent exceeds the Cap, then the landlord must return the excess to the tenant's bankruptcy trustee. 11 U.S.C. § 541

4. State law may also place limitations on the use of security deposits. For example, California Civil Code § 1950.7 limits the application of a security deposit to past due rent and accrued damages and precludes application toward prospective damages. *Public Employees' Retirement System v. Winston*, 209 Cal. App. 3d 205 (1st Dist. Ct. App. 1989). In some states, a landlord may only apply the security deposit toward the payment of rent, costs to repair damage to the premises and costs to clean the premises. Consequently, most landlords attempt to define "rent" very broadly to include all of the tenant's payment obligations. Additionally, rent is narrowly defined in the case of *In re McSheridan*, 184 B.R. 91, 99 (9th Cir. BAP 1995) as a charge which is either designated as "rent" or "additional rent" in the lease, or is expressly tenant's obligation to pay pursuant to the lease, and which is related to the value of the property or the lease, and is properly classified as rent because it is a fixed, regular or periodic charge. *McSheridan* thus precludes the landlord from treating attorneys' fees, court costs and unamortized tenant improvement costs as rent. As discussed in Part V below, it may be prudent to expressly carve certain tenant payment obligations (such as the obligation to pay for tenant improvements) out of the lease and separately document a loan to the tenant so that the repayment of the loan is not treated as payment of rent, which is subject to the Cap.

5. State law may require the landlord to return the unapplied portion of the security deposit to the tenant within a relatively short period of time. For example, in California, security deposits must be returned within two weeks (if the security deposit exceeds one month's rent) or within 30 days (if the security deposit does not exceed one month's rent) after landlord recovers possession of the premises. Cal. Civ. Code § 1950.7(c).

Because the preference period is 90 days, a landlord may not be able to determine the full amount of its damages until after the security deposit has been returned to the tenant.

### Part III. Guaranties

The major advantage of a guaranty over a security deposit is that, if it is structured properly, a guaranty can provide security for all of a tenant's obligations under a lease and not be limited to the Cap. Ideally, a well drafted guaranty should put the landlord in at least the same position as it would have been had the guarantor been the entity executing the lease. The downside to the use of a guaranty is that it does not provide readily available cash, like a security deposit or letter of credit and, often, a lawsuit may be necessary to collect on the obligation.

Although most experienced landlord attorneys have developed good form files and can print-out a state of the art guaranty by clicking a few buttons on their computer, there are many instances when one is forced to accept a deficient form. One may represent a client who purchases commercial property with leases and guaranties in place requiring an analysis of existing guaranties with no ability to renegotiate same. There are also instances when a landlord's attorney is confronted by a national or regional tenant with strong bargaining power whose parent delivers a short guaranty with a "take it or leave it" approach to the negotiation. Additionally many commonly used printed forms of commercial leases contain a signature line for a three sentence guaranty. In such instances it is important to understand and advise your client on the risks involved with relying on such limited guaranties. This section will analyze typical provisions in a well drafted guaranty in an attempt to address the reasons and justifications for particular provisions as well as the various types of guaranties generally used in leasing transactions.

**Practice Note:** Analysis of the creditworthiness of the guarantor is critical. In the event that the guaranty is provided by an individual, inclusion of the spouse may be very helpful to maximize resources available to pay out a potential judgment. Joint and

several liability provisions are also beneficial in this regard. In community property states, if the spouse of the guarantor is not willing to be a co-guarantor, it will make enforcement of the guaranty easier if the guarantor's spouse acknowledges in writing that the spouse consents to the guarantor encumbering one-half of the community property assets.

### 1. Consideration.

To be enforceable, a guaranty of a lease must be supported by adequate consideration; failure of consideration constitutes a valid defense for the guarantor. Typically, guaranties are signed simultaneously with the lease and the lease constitutes adequate consideration for its guaranty. However, a guaranty of a lease given after execution of a lease and with no contemplation in the lease for the delivery of the guaranty at that time is void unless the landlord gives some consideration for the guaranty, such as extending the term or waiving the right to withhold landlord's consent to an assignment where such consent could otherwise be withheld at the landlord's discretion.<sup>1</sup>

### 2. Guaranties of Payment vs. Guaranties of Collection.

(a) A "guaranty of payment" is an unconditional or absolute undertaking that the tenant will make a payment it is required to make under the lease. With such a guaranty, the landlord may, upon default by tenant beyond any applicable grace period provided in the lease, proceed directly against the guarantor, without taking any steps to collect the amount due from the tenant. See *Consolidated Steel Corp. v. Pressed Steel Car Co.*, 194 N.Y.S. 649 (N.Y. Sup. Ct. 1922).

(b) A "guaranty of collection" conditionally binds the guarantor to pay only after all attempts to obtain payment from the tenant have failed. The landlord must demonstrate that it is useless to proceed against tenant for payment (i.e. tenant is insolvent). Accordingly, the exercise of due diligence by the landlord to collect the underlying debt is a condition of the guarantor's obligation to pay under this form of guaranty and the guarantor is not liable until the condition is met. *Tucker Leasing Capital Corp. v. Marin Medical*

*Management*, 833 F. Supp. 948 (E.D.N.Y. 1993). A guaranty of collection may take years and extensive litigation costs to realize the ultimate benefit of the guaranty.

(c) Given the time and expense involved in litigation, it is advantageous for a landlord to demand a guaranty of payment and not of collection and to include an express covenant in the guaranty allowing the landlord to enforce a guaranty without first asserting claims against the tenant under the lease.

### 3. Subrogation.

The guarantor, upon being held liable under the guaranty, acquires an immediate right of subrogation to the rights of the landlord against the tenant to the extent necessary to obtain reimbursement for sums paid by the guarantor pursuant to the terms of the guaranty. See *Scarsdale Nat'l Bank & Trust Co. v. United States Fidelity & Guaranty Co.*, 264 N.Y. 159 (N.Y. 1934). It is thus important to include a clause in the guaranty either providing that the guarantor waives its rights of subrogation or that the guarantor will not exercise its subrogation rights until all amounts payable under the guaranty agreement have been paid in full. This will ensure that the guarantor will not deplete whatever limited resources are available from the tenant under the lease.

### 4. Modifications, Terminations and Amendments of Leases.

(a) Under the usual principles of surety law, any material modification of the lease without the guarantor's consent will relieve the guarantor of liability under the guaranty.<sup>2</sup> Under old common law, a guarantor could be released even if the amendment benefited the guarantor. The law has generally evolved such that the amendment must be material and adversely affect the guarantor's obligations in order to release the guarantor. Most well drafted guaranties will contain provisions keeping the guarantor liable despite any amendments, modifications or, terminations of the lease. A common compromise is to clarify that the guarantor will not be liable for any increased obligations imposed by any lease amendment made without the guarantor's consent.

(b) There is case law holding that if a lease prohibits any assignment or sublease and the landlord consents to an assignment or sublease, the guarantor will be released. Courts have viewed this as a modification of the underlying obligation. However, if the lease granted the tenant the right to sublease or assign with the landlord's consent, courts have held that such an event is pursuant to, and not in contravention of, the lease, and have not released the guarantor from subsequent liability.

To avoid the possibility of releasing a guarantor as a result of an amendment of the underlying lease, it is advisable not only to have strong language to the contrary in the guaranty, but also to have the guarantor expressly consent to any amendment or modification of the lease, no matter how minor such amendment may be.

(c) Absent language to the contrary in the guaranty, release of any security in a lease whether by release of a co-tenant, a release of securities or a release of a co-guarantor releases the guarantor. However, acceptance by the landlord of additional security or substitution of security has been held not to release the guarantor.<sup>3</sup>

In *Amerishop Mayfair, L.P. v. Billante*, 833 So.2d 806 (Fla. Ct. App.2002), the court held that a landlord's release of a tenant from liability under its commercial lease also released the guarantor in light of language in the guarantee that provided that:

"the obligations of the Guarantor herein shall be extensive with and shall remain in effect as long as Tenant's obligations in and under said Lease, and all extensions or modifications thereof shall continue, and as long as said Tenant shall be liable, Guarantor shall be liable thereunder in the same manner and in the same effect...."

The opposite result was reached in *New Market Acquisitions, Ltd. v. Powerhouse Gym*, 154 F. Supp.2d 1213 (S.D. Oh.2001), where the guarantor expressly agreed in the guaranty to remain liable for all damages even where the landlord released the tenant from further obligations. The court noted that but for such language, the settlement

agreement reached with the tenant would have discharged the guarantor.

### 5. Notices.

An absolute or unconditional guaranty is generally construed to require no notice to the guarantor upon a default of tenant. This puts the onus on the guarantor to ensure that the tenant is performing its obligations under the lease. Usually, a landlord is not required to give a guarantor notice of successive defaults by a tenant, unless required to do so under the guaranty. To remove any uncertainty, it is recommended that the guaranty specify whether or not notices are required and, if representing a landlord, an attorney should seek to eliminate any notice requirement to avoid a situation where the guarantor argues that its failure to receive notice prejudiced its rights and that it should consequently be released from its obligations under the guaranty. One of the practical problems that landlords have when notice to a guarantor is required under the guaranty is that in long-term leases, there may be several assignments of the lease and landlords want to avoid having to notify a long list of parties.

### 6. Renewals.

It is important to include in the guaranty provisions making clear that the guarantor remains liable for any renewal options under the lease as well as for any holding over by tenant beyond the expiration of the term. There have been cases, albeit a minority view, that hold the guarantor is only liable for the original term of the lease. Courts will attempt to construe the intent of the parties as expressed in the lease and guaranty in attempting to determine the duration of the obligation.<sup>4</sup>

### 7. Waiver of Jury Trials.

In order to ensure a quick recovery, and avoid the unpredictable nature of a jury, it is advisable to have the guarantor waive any rights to a jury trial in states where it is legal to do so. Note that in California pre-dispute jury trial waivers are not enforceable unless the parties have agreed to resolve disputes by judicial reference or arbitration. See *Woodside Homes of California, Inc. v. Superior Court of San Joaquin County*, 142 Cal. App. 4th 99, 104 (3rd Dist. Ct. App. 2006). In

many jurisdictions, specific and conspicuous language must be included in order for the waiver to be upheld. See *Connecticut Savings Bank v. Quinlan*, 1995 WL 371046, 14 Conn. L. Rptr. 592 (Conn. Super.Ct. June 14, 1995) (unpublished opinion).

### 8. Jurisdiction.

A well drafted guaranty will include a forum selection and choice of law provision especially if the guarantor is located in a different jurisdiction from the landlord. In order to avoid delays caused by claims of improper service, it is also advisable to have the guaranty appoint an agent for service of process. This issue is particularly important for guaranties by foreign companies. In such cases, it may be helpful to obtain an enforceability opinion from local counsel to ensure, at a minimum, that the guaranty is enforceable against the guarantor, that the choice of the state law would be respected by the foreign court, and that a judgment obtained in the state of choice could be enforced against the guarantor by the foreign court.

### 9. Interpretation.

A guarantor's obligations must be strictly construed according to the terms of the guaranty and cannot be altered, extended, or enlarged without the guarantor's consent. The guarantor cannot be held responsible to guarantee a performance different from that identified in the guaranty. *Continental Airlines v. Lelakis*, 943 F. Supp. 300 (S.D.N.Y. 1996) (citing *Fehr Bros., Inc. v. Scheinman*, 121 A.D.2d 13, 509 N.Y.S.2d 304 (N.Y.A.D. 1 Dept., 1986)).

### 10. Snap Back Provisions.

These are provisions in guaranties conditioning a guarantor's liability on the ability to take back possession of the premises for the remainder of the term of the lease after a tenant default. The snap back offers the guarantor an opportunity to mitigate its damages by either utilizing the space or by attempting to assign or sublet the space rather than simply being liable for the remainder of the lease. The provision is more critical in circumstances wherein the lease is assigned and there is no longer an affiliation between the guarantor and the tenant.

### 11. Good Guy Guaranties.

A good guy guaranty differs from a personal guaranty by virtue of the guarantor's limited liability to pay rent for only that period of time that the tenant remains in possession of the leased premises. In the event that the party providing the good guy guaranty is not the tenant, after the release of the guarantor, the landlord still has the right to sue the tenant for damages for the remainder of the lease term or any other performance requirements. However, the guarantor has fulfilled all of its obligations.

There are three common forms of good guy guaranties:

(a) Most favorable to tenant: only requires the tenant to deliver the vacant premises to the landlord. Once this is done, the guarantor is released from all further liability accruing from and after such date.

(b) Most favorable to landlord: requires delivery of the vacant premises with all monetary and performance obligations fulfilled through the date of delivery, including the restoration of the security deposit if the landlord used any monies to cure the tenant's default. Tenants must be careful that a landlord does not accelerate rent upon a default of tenant thereby converting the good guy guaranty into a full blown guaranty.

(c) Middle ground: requires delivery of the premises with all monetary obligations fulfilled through the date of delivery, but does not require fulfillment of performance obligations, or limited fulfillment of obligations.

When drafting good guy guarantees and any other guaranty containing a cap or limit on the amount of a guarantor's potential liability, it is critical to provide that any costs and expenses incurred by the landlord in enforcing the guaranty shall not be limited by such cap. It should also be noted that some good guy guaranties provide that the guarantor remain liable for a certain period after possession of the space is delivered to the landlord to compensate for lost rental during the time it takes to re-lease the premises.

See Appendix A for sample guaranty of a

corporate parent (available upon request).

### Part IV. Letters of Credit

1. **Advantages of LOCs to tenants.** An advantage to a tenant in providing a letter of credit (LOC), rather than a security deposit or prepaid rent, is that the LOC will not necessarily tie up the tenant's cash or other liquid assets. Although the issuing bank may require the tenant to secure its LOC reimbursement obligations, the tenant may be able to use nonliquid assets, such as equipment, as collateral. Even if the issuing bank requires the tenant to secure its LOC reimbursement obligations with a certificate of deposit in an amount equal to 100% of the LOC amount, the tenant will be better off providing an LOC than a security deposit, because certificates of deposit earn interest (usually at rates significantly in excess of the fee for issuing the LOC, which is usually between one-half of one percent and one and one-half percent of the LOC amount) and landlords usually do not pay interest on security deposits.

#### 2. Advantages of LOCs to landlords.

(a) Under state law, an LOC is an independent obligation of the issuing bank. See Uniform Commercial Code (UCC) § 103(d). See also, *In re Prime Motor Inns, Inc.*, 130 B.R. 610 (S.D. Fla. 1991) in which the court held that an LOC is a separate and independent obligation of the issuing bank and therefore drawing down upon an LOC is not a violation of the automatic stay even though a draw upon the LOC would trigger the debtor's obligations under a reimbursement agreement between the debtor and the issuing bank.

(b) Even if the tenant disputes the landlord's claim, the issuing bank must honor a conforming draw on the LOC. A landlord's draw under an LOC cannot be enjoined by the tenant unless the tenant can show fraud and satisfy all other conditions for equitable relief. See *In re Prime Motor Inns, Inc.*, 130 B.R. 610, 612 (S.D. Fla. 1991) where the U.S. District Court held that the Bankruptcy Court did not have jurisdiction to enjoin either payment, or distribution of proceeds under LOC contracts to which the debtors were not parties. Typically,

equitable relief will not be granted unless the party seeking the injunction, in this case, the tenant, can show: probable success in proving its allegation of fraud; irreparable harm; no adequate remedy at law; the balance of the equities favors the tenant; and the public interest is being served. In some cases, a bond must be posted by the tenant seeking to enjoin a draw against an LOC to preserve the landlord's rights in the event the LOC is enjoined until after it expires. Additionally, in most states (New York and New Jersey being notable exceptions) UCC § 5-111(e) requires the unsuccessful party in an action to enjoin a draw upon an LOC to pay the prevailing party's attorney's fees.

(c) Neither the LOC nor the proceeds of a draw upon an LOC are included in the property of a bankrupt tenant's estate. Bankruptcy Code, 11 U.S.C.A. § 541(a); *In re Mayan Networks Corporation*, 306 B.R. 295, 299 (9th Cir. 2004). Provided the LOC does not exceed the Cap, the proceeds of a draw against an LOC can be applied to the landlord's accrued damages without seeking relief from the automatic stay if the tenant is in bankruptcy. *In re Mayan Networks Corporation*, 306 B.R. 295, 300 (9th Cir. 2004). Immediate application of draw proceeds to landlord's termination damages reduces the risk that the proceeds will be transformed into a security deposit which is subject to the jurisdiction of the bankruptcy court, as well as the application of the Cap.

(d) Draws on an LOC are not deemed preference payments so long as the LOC was entered into when the lease was signed, or after the lease commenced but before the 90 day preference period commenced (i.e., 90 days prior to the date the tenant filed for bankruptcy protection). See Bankruptcy Code § 547(b) and *In re ITXS, Inc.*, 318 B.R. 85, 87 (W.D. Pa. 2004).

3. **Standby LOC.** A standby LOC should be used to secure lease obligations, rather than a commercial LOC. A commercial LOC is designed to be used to pay for goods purchased in international trade. A standby LOC is intended to be drawn upon only in the event of a lease default.

4. **ISP98 vs. UCP.** It is better to specify the International Standby Practices 1998

(ISP98) promulgated jointly by the Institute for International Banking Law and Practice and the International Chamber of Commerce (ICC) (found in ICC Publication No. 590) than the Uniform Customs and Practice for Documentary Credits (UCP) promulgated by the ICC (found in ICC Publication No. 600) as the governing rules for a standby LOC.

#### (a) Benefits of ISP98:

- Specifically designed for standby LOCs, the ISP98 includes basic definitions, permits electronic (rather than in-person) presentations, has clearer rules on standby LOCs and explains the intent implied in the UCP rules.
- Contains provisions that avoid many pitfalls in UCP.

#### (b) Pitfalls of using UCP:

- UCP does not provide for the contingency of the issuer not being open for business due to force majeure, so if the issuer is closed when the beneficiary wishes to draw upon the LOC and does not reopen before the LOC expires, the beneficiary cannot draw upon the LOC. The fact that many banks were closed for several days, and some for much longer, after the terrorist attacks of September 11, 2001 and hurricanes in Louisiana, Florida and Mississippi, highlights the need for a force majeure provision. Under ISP98, if the issuer is closed on the last business day the beneficiary could have drawn upon an LOC, the beneficiary has an extra 30 days from the day the issuer reopens for business to present the documents necessary to make a draw upon the LOC. See ISP Rule 3.14.
- Under the UCP, if installment draws are contemplated and one or more installments draws are not made, the beneficiary cannot make subsequent draws. No such prohibition is included in ISP98.
- Documents (and data within the documents) to be presented in order to draw on the LOC cannot be inconsistent under the UCP. Under ISP98, each

document presented must comply with the LOC, but the issuer is not required to examine data within those documents for inconsistencies with data in other documents unless the LOC expressly requires it. See ISP Rule 4.03.

### 5. LOC drafting tips.

(a) Keep draw conditions simple. It is easier to make an error-free draw if the LOC calls for few documents, minimizes the required wording in the documents to be presented, and does not require the wording of the draw documents to be exactly the same as the language in the LOC.

(b) Do not require that a sight draft be presented in order to draw upon an LOC. Sight drafts are appropriate for commercial LOCs because the draft is endorsed by the drawer over to the negotiating bank and the negotiating bank has the right to be paid by the issuer. Standby LOCs are “straight” credits payable only to the named beneficiary (or its transferee, if the LOC is transferable). A “straight” LOC does not nominate another bank to negotiate or purchase drafts presented by the beneficiary to make a draw upon the LOC. Since standby LOCs are not negotiable, there is no reason to require a sight draft in order to make a draw. Instead, the LOC should simply require the beneficiary to submit a demand identifying the LOC and specifying the date of the draw demand, the amount of the draw, the reason for the draw and to whom (and to what bank account) the draw proceeds should be wired.

(c) Do not limit who is permitted to draw against an LOC to persons identified by name. If the LOC only allows a named individual to make draws and the named individual is no longer employed by the landlord, or is no longer living, the landlord/beneficiary will not be able to draw against the LOC because the issuer is not obligated to honor a draw made by another individual unless the LOC is expressly made transferable and the terms of the transfer are followed. The court upheld the issuer’s right to dishonor a draw made by an assignee of the named individual landlord’s estate when that named individual had died and his personally signed certificate was required

to draw against an LOC securing a tenant’s obligations in *Samuel Rappaport Family Partnership v. Meridan Bank*, 657 A.2d 17, 22 (Pa. Super. Ct. 1995).

(d) Issuers will not agree to be responsible for determining the authority of the person executing the draw requests, or the genuineness of their signatures, so the LOC should provide that a draw may be made if it is signed by a person who purports to be an authorized officer or representative of the beneficiary.

(e) To avoid the implication that the draw certificate must be a verbatim copy of the language in the LOC, the draw request language called for in the LOC should not be set off in quotation marks or in block quote style nor should a form of draw be attached as an exhibit. See ISP Rule 4.09 Note that in the sample LOC attached as Schedule 1 to Appendix “B” (available upon request), a draw request must simply state the necessary elements “in substance.”

(f) Avoid any conditions on drawing against the LOC which require presenting any document that must be signed by the tenant or any other party not controlled by landlord. Do not condition a draw upon the tenant being in default or in an event of default if the lease defines either term as a default that continues after notice and lapse of the applicable cure period, because landlord will not be able to deliver a notice of default to the tenant which terminates the lease without relief from the automatic stay if the tenant goes into bankruptcy; instead, provide for the landlord to simply represent that the tenant has breached the terms of the lease.

(g) An LOC is not transferable unless it expressly states that it is transferable. If the landlord sells the property, the purchaser will want all the LOCs securing obligations of the tenants of that property transferred to it. Similarly, a landlord’s lender will want the LOCs to serve as additional collateral for the loan to the landlord secured by the leased premises. Each LOC should contain express language designating the LOC as a transferable LOC. The LOC should refer to, and contain exhibits showing the form of,

a transfer notice and specify the maximum transfer fee the issuer will require upon a transfer of the LOC.

(h) An assignment of the proceeds of an LOC is accomplished by an acknowledgment of the issuer that the assignee has the right to be paid a designated portion, or all, of the proceeds of a draw on the LOC; whereas a transfer of an LOC transfers the right to draw on the LOC. A landlord’s lender will view the LOCs securing the tenants’ obligations as additional collateral for the loan to the landlord and will want to 1) perfect its security interest in the LOCs, 2) obtain control of the LOCs in the event of a landlord loan default, and 3) specify the conditions for when the LOCs may be drawn upon and how the proceeds of any draw will be applied. Landlords are usually unwilling to transfer LOCs to their lender because it gives the lender the ability to make draws against the LOC. Lenders tend not to insist on a transfer of the landlord’s LOCs because they know that they are usually not the best party to determine when a tenant is in default, and they want to avoid the risk that they may be held liable for damages and attorneys’ fees if they make a wrongful draw against an LOC; consequently, it is more common for a landlord to make a collateral assignment of the proceeds of an LOC to its lender. Under revised Article 9 of the UCC, a landlord’s lender can perfect its security interest in the proceeds of a draw on an LOC by obtaining from the issuer of the LOC an acknowledgment of assignment of the LOC proceeds under UCC § 5-114(i). See UCC §§ 9-107, 9-132(ii)(b), 9-314(i), (ii).

(i) Allow landlord to make partial and multiple draws against the LOC. This will allow the landlord to draw only the amount in default without having to terminate the lease and without the risk that any portion of the draw proceeds not applied to sums then due and owing by the tenant may be treated as a security deposit.

(j) Do not require the landlord to specify the use of the funds to be drawn other than in the most general manner, such as “pursuant to the terms of the lease” or “on account of a default under the lease.” If the landlord is required to place the funds into

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an escrow, the landlord may need to obtain a court order to get them out of escrow.

(k) The expiration date of the LOC should be more than 90 days after the date of the last payment made by tenant pursuant to the terms of the lease. To protect against the possibility of having to give back payments made by a tenant during the 90 day preference period (i.e., the 90 days immediately preceding the day the tenant files for bankruptcy), the LOC should remain in effect until the preference period has lapsed. Ideally, the LOC should remain in effect for 30 days after the preference period has lapsed to give the landlord sufficient time to determine the amount of damages the landlord has incurred and to present an error-free draw against the LOC to the issuing bank.

(l) If a landlord suspects that a tenant is at risk for filing for bankruptcy, then if the tenant does not pay its rent on time during the last 3 months of the term, the landlord should consider drawing against the LOC rather than accepting late payments of rent as the draw proceeds are funds of the issuing bank and not the debtor, and thus are not preference payments that can be recovered by the bankrupt tenant's estate. See *In the Matter of Xonics Imaging Inc.*, 837 F.2d 763, 766 (7th Cir. 1988) where the 7th Circuit held that the debtor's late payments of rent and taxes were not paid in the ordinary course of business and thus were avoidable preferences. See also, *In re Powerine Oil Co. v. Koch Oil Co.*, 59 F.3d 969, 972 (9th Cir. 1995) where the 9th Circuit determined that a preference payment had been made because the creditor accepted late payments rather than drawing against the LOC. For an analysis of when a late payment might be deemed to be made in the ordinary course of business see *In re GGS Liquidation, Inc.*, 313 B.R. 770, 776-777 (N.D. Ill. 2004) and *In the Matter of Xonics Imaging Inc.*, 837 F.2d 763, 765-767 (7th Cir. 1988).

(m) Add a "clawback" provision in the lease (or security agreement) and the LOC which permits the landlord (or beneficiary) to draw against the LOC in an amount equal to the sum of the amounts paid by the tenant during the preference period so

that in the event the tenant/applicant files for bankruptcy and recovers those amounts as preference payments, the landlord will be able to draw upon the LOC and be made whole with respect to any preference claims made.

(n) Shorten the time period for the issuer to honor a draw against the LOC. Unless the LOC expressly specifies the time to honor, the UCC, the UCP and the ISP98 all provide that an issuer of an LOC has a reasonable period of time (up to 7 business days after the draw is presented) to honor the draw request or give notice of dishonor. Two business days is ample time for an issuer to honor a draw. If the LOC is about to expire, the shorter time period to honor a draw request will give the landlord more time to correct and resubmit a dishonored draw request.

(o) Although issuers frequently want to issue presentment LOCs, which require the beneficiary to present the original LOC in person in order to make a draw against the LOC (arguably so that the issuer has some assurance that the true beneficiary is making the draw request), this can present serious problems for a landlord. If the original of the LOC is lost or destroyed, the landlord will not be able to draw against the LOC. Cases have consistently held that copies are not permitted as substitutes for lost original presentment LOCs and the issuer has no duty to issue a duplicate original. See, e.g., *Brul v. MidAmerican Bank & Trust Co.*, 820 F. Supp 1311, 1313-1315 (D. Kan. 1993) (upholding the issuer's dishonor of a draw request when only a copy of the LOC was presented, even though it was accompanied by an indemnity and an affidavit that the original was lost and had not been assigned or transferred). Neither the UCC nor the UCP has a rule on lost original LOCs, and the ISP98 rule merely allows (but does not require) the issuer, at the issuer's discretion, to replace a lost original LOC. If the issuer insists on presentment of the original LOC, consider adding a provision to the LOC which requires the issuing bank to replace a lost, stolen or destroyed LOC upon receipt of a reasonable indemnity from the beneficiary. If the issuing bank insists

on presentment of the original LOC and refuses to agree to replace a lost, stolen or destroyed LOC upon receipt of a reasonable indemnity, another alternative to consider (although clearly less satisfactory to the beneficiary) is to have the beneficiary deliver the original LOC (and any amendments) to the issuer to be held on the beneficiary's behalf to facilitate presentments to be made in connection with any drafts drawn on the LOC. If that approach is followed, then it is imperative that the issuer deliver a receipt to the beneficiary which clearly states that the original LOC has been delivered to facilitate presentments to be made in connection with any drafts drawn and that the issuer agrees that proper presentment has been made in connection with any subsequent requests to draw upon the LOC.

(p) LOCs are usually issued for a period of one year or less. Leases are usually for terms in excess of one year. To ensure that an LOC is kept in place for at least the term of the lease (and as discussed previously, preferably for at least 120 days beyond the termination of the lease to allow the landlord to make draws to be reimbursed for any preference payments recovered by a bankruptcy trustee) the LOC should include an automatic renewal provision that states that the LOC will be automatically renewed for additional one year periods unless the issuer notifies the landlord at least 60 days before the expiration date that the LOC will not be renewed. The lease and the LOC should also provide that if a notice of non-renewal is given before the obligation to maintain the LOC expires, and the tenant fails to deliver a replacement LOC to the landlord at least 30 days before the expiration of the LOC, the landlord may draw on the LOC by submitting a document stating that the issuer failed to timely renew the LOC. To avoid the need to seek relief from the automatic stay, the renewal or draw provisions should be drafted as an independent ground for the draw, separate from a default under the lease. This enables the landlord to apply the proceeds of a draw upon the LOC to cover landlord's damages before the LOC expires. The lease should provide for what happens to the funds drawn against the LOC due to non-renewal of the LOC. Unless there is a current default

(other than the failure to renew the LOC) there may be no unpaid monetary defaults to apply the draw proceeds against. The funds could be held as substitute collateral, or a security deposit or placed into an escrow until such time as there is a tenant default, but if the tenant is in bankruptcy, all such funds will be treated the same way security deposits are treated and thus are subject to the jurisdiction of the bankruptcy court. Usually the failure to extend an LOC is due to the issuer's concern with the tenant's financial condition, so it is advisable to also make the failure to renew the LOC an event of default under the lease.

(q) Verify the creditworthiness of the issuing bank. Bank rating services, such as Fitch Ratings ([www.fitchratings.com](http://www.fitchratings.com)), are available to check on the financial strength of the issuer. If the issuer's credit is shaky, consider requiring a creditworthy confirming bank to confirm the LOC, which allows the beneficiary to present the draw request to the confirming bank and the confirming bank then is authorized to debit the issuer's account for any draws made against the LOC. If the issuing bank does not have a local branch, consider requiring an advising bank with a local bank, which can accept presentment of a draw on the issuing bank's behalf.

(r) Make sure the conditions to make a draw on the LOC will not violate the automatic stay if the tenant goes into bankruptcy. The court in *In re Sixteen to One Mining Corp.*, 9 B.R. 636, 638 (D. Nev. 1981) explained that the mere giving of a notice of default will not violate the automatic stay, but a notice purporting to terminate the lease or attempting to obtain possession of the premises will violate the stay and be considered null and void. Therefore, the language of the notice should be carefully drafted.

(s) The tenant's obligation to restore the premises and pay for hazardous waste clean-up costs should not be characterized as "rent." The Ninth Circuit recently held that cost of cleaning up hazardous materials brought onto the premises by the tenant (i.e., the landlord's collateral damages) had no correlation to loss of future rental income

under a lease and was not subject to the Cap. *Saddleback Valley Community Church v. El Toro Materials Company, Inc.*, 504 F.3d 978, 980 (9th Cir. 2007). Landlords leasing to tenants that may be involved in the use, storage or disposal of hazardous materials should consider requiring a separate LOC to secure the tenant's obligations to restore the premises, as those claims are not capped.

### 6. What happens when you draw upon the LOC?

(a) Case law is somewhat divided regarding whether the Cap described in Bankruptcy Code Section 502(b)(6) applies to the proceeds of draws upon LOCs. Pursuant to *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 921 (2nd Cir. 1944), the Second Circuit Court of Appeals held that when a tenant goes into bankruptcy, any security deposits held by the landlord must be applied to the Cap, and any security deposit in excess of the Cap must be returned to the tenant's bankruptcy estate.

The Third Circuit Court of Appeals used *Oldden* as a jumping off point and, ignoring the principle of independence, held in *In re PPI Enterprise (U.S.), Inc.*, 324 F.3d 197 (3rd Cir. 2003) that a letter of credit given "in lieu" of a security deposit was essentially the same as a security deposit and thus subject to the Cap.

However, the Fifth Circuit Court of Appeals held in *In re Stonebridge Technologies, Inc.*, 430 F.3d 260, 269-270 (5th Cir. 2005) that the Cap did not apply to limit the landlord's entitlement to the proceeds of a draw on the LOC because the landlord never made a claim against the bankruptcy estate and the Cap only limits a landlord's claim, if presented, against the bankruptcy estate.

The Ninth Circuit Court of Appeals held in *In re Mayan Networks Corporation*, 306 B.R. 295, 299 (9th Cir. 2004) that one must look at the impact the draw on an LOC has on the property of the bankruptcy estate. In the *Mayan* case, the Ninth Circuit held that since the bankrupt tenant's cash was pledged as collateral to the issuing bank, a draw upon the LOC would allow the issuing bank to pursue recovery of its loss against the debtor which would impact the property of the

debtor's estate and thus the court determined that the Cap should apply to the proceeds of a draw upon an LOC. To prevent an "end run" around the Cap, the Ninth Circuit found that the parties intended the LOC to be security for the tenant's obligations under the lease and, even though the words "security deposit" were not used, the LOC was essentially a security deposit and thus subject to the Cap. The *Mayan* court noted that the lease treated the LOC as if it were a security deposit because the tenant was liable to replenish the security if the landlord was forced to draw upon the LOC.

The court distinguished the case of *In re Condor Systems, Inc.*, 296 B.R. 5 (9th Cir. 2003) where the pertinent Cap was not reduced by proceeds of draws upon an LOC because the debtor had not provided any security to the issuing bank and thus payments made by the issuing bank on the LOC had no impact on the debtor's estate. Judge Klein's concurring opinion in the *Mayan* case clarifies that an LOC is not actually the equivalent of a security deposit, but more like a "powerful guaranty in which the issuer winds up with the same bankruptcy rights [of subrogation] as other guarantors..." *In re Mayan Networks Corporation*, 306 B.R. 295, 301 (9th Cir. 2004).

In light of *Mayan*, to avoid having an LOC treated as a security deposit it would be preferable to draft your LOC to clarify that neither the LOC, nor the proceeds of the LOC, belong to, or are refundable to, the tenant (although most tenants would push back against such a suggestion). Similarly, it would be preferable to have the guarantor or a corporate parent of the tenant supply the LOC and clarify that refunds of unused LOC proceeds, if any, will be made to the guarantor or corporate parent that provided the LOC.

(b) As noted above, security deposits are considered part of a debtor's estate and are subject to the Cap. Once the LOC is drawn against and the landlord receives the proceeds, do those funds convert into a security deposit? Because the lease indicated that the LOC was security for the tenant's obligations under the lease, the court in the *Mayan* case held that the proceeds of a draw

on that LOC were the equivalent of a security deposit and thus subject to the Cap. *In re Mayan Networks Corporation*, 306 B.R. 295, 301 (9th Cir. 2004). See also *In re Connectix Corp.*, 372 B.R. 488 (N.D. Cal. 2007) where the court held that prepetition draws against the LOC that served as security for a tenant's obligations under a lease would not be applied to the landlord's gross damages, but would reduce the landlord's capped claim in bankruptcy.

But those decisions ignore the principle that a LOC is an independent obligation of the issuing bank endorsed in the case *In re Prime Motor Inns, Inc.*, 130 B.R. 610, 614 (S.D. Fla. 1991), where the U.S. District Court held that "[a]lthough Congress gave this Court and the Bankruptcy Court expansive powers to protect debtors, no provision of law permits interference with letters of credit contracts to which no debtor is a party." See also *In re Farm Fresh Supermarkets of Maryland, Inc.*, 257 B.R. 770, 772 (D. Md. 2001) where the court determined the Cap without regard to the LOC because property of the debtor's estate does not include the proceeds of an LOC. Note that although the bankruptcy trustee cannot enjoin a draw on an LOC, the trustee can recover proceeds of a draw upon the LOC to the extent such proceeds exceed the landlord's damages. *First Ave. West Building, LLC v. James (In re Onecast Media, Inc.)*, (9th Cir. 2006) 439 F.3d 558, 564.

If the lease and the LOC are carefully drafted to avoid equating the LOC to a security deposit and the proceeds drawn from the LOC do not exceed the amount of landlord's accrued damages and are applied toward such sums as are then due and owing, an argument could be made, even after the *Mayan* decision, that such a draw should not be subject to the Cap; but courts attempting to use the *Oldden* and *Mayan* cases to broaden the reach of the bankruptcy court may still insist that such proceeds are subject to the Cap.

(c) What if the LOC proceeds are applied to cure outstanding defaults? Arguably, LOC proceeds applied directly to cure outstanding defaults are not transformed into a security deposit and thus are not subject to the Cap. In the case *In re PPI Enterprises*

(*U.S. Inc.*, 324 F.3d 197 (3rd Cir. 2003) the Third Circuit Court of Appeals held that the lease in question clearly indicated that the parties intended the LOC to operate as a security deposit and so when money was drawn against the LOC and held in lieu of a security deposit it was subject to the same Cap that would apply to a security deposit. The case did not address the situation where a landlord draws against an LOC and applies the proceeds to cure a default, rather than holding the funds as a substitute security deposit. This suggests that it may be possible for a landlord to draw against an LOC only the amount then actually in default and apply those proceeds immediately to cure the default, rather than draw the entire LOC and hold the excess amount as a security deposit. The court in *In re ITXS, Inc.*, 318 B.R. 85, 87 (W.D. Pa. 2004) held that even if the *Oldden* and *PPI Enterprises* cases establish that a debtor retains an interest in a security deposit until the security deposit is validly set off, the tenant/debtor never possessed any property interest in LOC proceeds which are not held as a security deposit, and thus the draw on the LOC did not constitute an avoidable preference. For this reason it is very important that the LOC be drafted to permit multiple partial draws.

(d) If tenant is in bankruptcy should a landlord file a proof of claim? When a tenant files for bankruptcy protection, a landlord may be better off if it does NOT file a claim against the debtor's estate if the landlord is holding an LOC securing the tenant's obligations. The Fifth Circuit Court of Appeals in *In re Stonebridge Technologies, Inc.*, 430 F.3d 260, 269 (5th Cir. 2005) held that the landlord's "need to file a claim against the bankruptcy estate was obviated by the fact that the Lessee's obligations were substantially secured by cash and a letter of credit, to which the Lessor turned when the Lessee defaulted." The court in *Stonebridge* went on to note that the Cap applies only to claims against the bankruptcy estate and that the formal filing of a claim by the landlord against the bankruptcy estate is an "essential precondition to applying the damages cap at all. Thus, the damages cap of § 502(e)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter

of credit unless and until the lessor makes a claim against the estate." 430 F.3d 260, 270.

(f) When should a landlord set off an existing security deposit against sums in default and/or draw against an LOC? In the case of *In re ITXS, Inc.*, 318 B.R. 85, 88-89 (W.D. Pa. 2004) the court found that a prepetition setoff of the security deposit against amounts then in default was not avoidable as a preference because a preference, under Bankruptcy Code § 547(b), requires a transfer of an interest of the debtor in property, and the definition of the term "transfer" in Bankruptcy Code § 101 intentionally omits "setoffs." Consequently, a landlord worried about a tenant's solvency, should immediately upon a default by that tenant, apply any security deposit the landlord is holding against past due rent and other sums then due and owing which the landlord is entitled to recover under state law. If the landlord is also holding an LOC, then, after the entire security deposit has been applied toward sums then due pursuant to the lease, the landlord should draw against the LOC in an amount equal to the balance of the landlord's accrued damages resulting from the tenant's default and immediately apply the proceeds of the draw against the sums due.

### Part V. Rent vs. Loan

1. Under state law (and to shore up the capitalization rate for the landlord's lender), it is usually beneficial to characterize all tenant payment obligations as rent; however, if the tenant's credit is shaky, you may consider structuring the deal so that the landlord requires the tenant to pay the tenant improvement costs, and possibly the broker commissions, in order to minimize landlord's exposure for out-of-pocket expenses. If tenant is unwilling or unable to front these costs, landlord may lend the tenant an amount equal to these out-of-pocket expenses and, rather than amortize these costs into the rent, document the loan with a promissory note, loan agreement and security agreement outside of the lease. Appendix "B" (available upon request) is a sample provision to insert in a security agreement, which calls for a separate LOC

that secures a separately documented loan to the tenant for the cost of the tenant improvements and brokerage commissions. Schedule 1 to Appendix "B" (available upon request) is a sample LOC that secures a loan to tenant outside of the lease. A landlord may also consider accepting equipment, accounts receivable or other non-liquid assets as collateral for such a loan.

2. Make sure the lease includes a provision which clarifies that it is the tenant's responsibility to pay for all of the tenant improvements and, if applicable, the brokerage commissions, if you structure the tenant's obligation to pay for tenant improvements and broker commissions as repayment of a loan, rather than amortizing those amounts into the rent.

3. Assuming that the tenant is unwilling or unable to pay for such costs upfront, and that the landlord is willing and able to lend a sum of money equivalent to the sum of such costs, the landlord should be careful to document such a loan outside of the lease and treat it as a completely separate transaction. Such a loan structure should be carefully documented as a secured creditor/debtor relationship to avoid any implication that the sums due under the loan are really disguised rent payments due under the lease and thus are subject to the Cap on landlord's claims for damages under the lease. To minimize the risk of repayment of such a loan being treated as disguised rent, the term of the loan should be different than the term of the lease (preferably shorter), the borrower should be an entity other than tenant (such as the guarantor or the parent company of the tenant) and a default under the loan agreement should not be cross-defaulted with a default under the lease. You should leave a clear paper trail that the transaction

is a separate obligation to repay a loan so that it will not be treated as being part of the tenant's lease obligations.

4. In order to properly document the loan as an obligation separate and apart from the lease, the borrower should be required to sign a promissory note, a loan agreement and a security agreement. The lease should not include the loan documentation as exhibits, nor should it make any reference to such loan.

5. The security agreement should contain language indicating that the loan is secured and identifying the collateral (e.g., a LOC, specified equipment, accounts receivable and/or other non-liquid assets).

### **Part VI. Securing the Duty to Complete Leasehold Improvements: Bonds and LOCs**

1. Weigh the cost of requiring payment and performance bonds for completion of leasehold improvements against the potential recovery.

2. If a contractor or subcontractor can obtain a bond, you probably do not need to require them to be bonded.

3. Consider forgoing the requirement for bonds if the tenant uses contractors and subcontractors from landlord's pre-approved list, or contractors and subcontractors approved by landlord.

4. Escrow funds to be used for payment of leasehold improvements.

<sup>1</sup> Milton R. Friedman, *Friedman on Leases* § 35:1 at 35-2 (5th ed. 2004) (citing *Standard Oil Co. v. Koch*, 260 N.Y. 150, 183 N.E. 278 (1932); (some citations omitted)).

<sup>2</sup> See Report of Committee on Leases, *Security Deposits and Guaranties Under Leases*, 1 Real Prop. Prob. & Tr. J. 430 (1966) (citing *Street v. Pacific Indemnity Co.*, 79 F.2d 68 (9th Cir. 1935); *Reese v. Mackentepe*, 224 Ala. 372, 140 So. 550 (Ala. 1932)).

<sup>3</sup> Milton R. Friedman, *Friedman on Leases* § 35:3 at 35-11 (5th ed. 2004) (citing *Prior v. Kiso*, 81 Mo. 241 (Mo. 1883); *Hall v. Boster*, 255 Mass. 262, 151 N.E. 109 (Mass. 1926) (some citations omitted)).

<sup>4</sup> See Report of Committee on Leases, *Security Deposits and Guaranties Under Leases*, 1 Real Prop. Prob. & Tr. J. 428 (1966).

*All Appendices and Schedules are available from the authors upon request.*

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