

Leasing to a Financially Weak Tenant

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Introduction

From time to time it makes good economic sense to lease to a financially troubled tenant: the market might be soft, it might be difficult to find a prospective tenant interested in the space, and this tenant, although in weak financial condition, certainly might succeed and make all required payments on the lease. This article will discuss some of the planning issues the landlord should consider in entering into a lease with such a tenant, will clearly identify the areas of the landlord's exposure, and will explain how the landlord should react to a default in order to minimize its loss.

At the outset, I assume that the landlord's chief objective (besides generating as much revenue as possible from the premises) is to recapture the premises as rapidly as possible after the tenant goes into default so that they may be relet to a performing tenant. I also assume that within the constraints of market conditions, the landlord will have extracted personal guaranties and security deposits, and will have limited or eliminated concessions such as tenant improvement allowances and free rent periods, when leasing to a weak tenant.

Consequences of a Default

Regardless of the structure of the lease, the landlord faces the same three types of damages if the tenant defaults: loss of rent until the landlord regains possession of the premises; out-of-pocket costs such as attorneys' fees associated with regaining possession of the premises; and losses associated with reletting the premises (such as lost revenues until the new tenant begins paying rent, broker's commissions and any concessions offered the new tenant). The landlord faces these three types of damages in every case, regardless of whether the tenant occupies the premises on a month-to-month lease or a long-term lease. The landlord can minimize the first two types of damages through effective planning and aggressive management; the third type of damage is a function of market conditions.

Absent the tenant's consent, the only way for the landlord to regain possession of the premises after a default by the tenant is through an unlawful detainer action. Unlawful detainer actions are intended to proceed rapidly: trial can often occur within 60 days of the commencement of the case. Unfortunately, unlawful detainer actions can cost thousands of dollars, and may result only in a judgment which must then be enforced by the sheriff: the process of enforcing that judgment can often result in additional delays of as much as two months. Thus, the landlord must anticipate substantial attorneys' fees and delays of up to, say, four months when it uses an unlawful detainer action to regain possession of the premises.

The tenant can derail the unlawful detainer process at any time by filing a bankruptcy case. In bankruptcy

cases, however, the landlord's position is far stronger: it will generally regain possession of the premises within a short and defined period of time and at much less expense. Unless the tenant agrees to abide by the lease, and brings it completely current by the 60th day following the filing, the Bankruptcy Court should require the tenant to vacate the premises immediately thereafter. Although the landlord should retain bankruptcy counsel to make sure that the 60-day deadline is enforced and the tenant actually vacate the premises, the provisions of the Bankruptcy Code tend to minimize the attorney's fees associated with evicting a tenant in bankruptcy.

Recommendations

A practical approach to the foregoing generates a handful of specific recommendations:

Negotiations and Drafting:

1. Long-term leases are preferable. The damages which a landlord suffers from a defaulting tenant are essentially the same regardless of the term of the tenancy. If the tenant is the subject or a long-term lease, however, the landlord can present a claim in the bankruptcy case (or obtain a judgment outside of bankruptcy, if it is economically warranted) for substantially all of its losses. On the other hand, the landlord cannot present a claim for significant damages in the case of the breach of a month-to-month tenancy, and the Bankruptcy Court is far less likely to enforce deadlines or require the debtor either to cure the lease (by paying pre-bankruptcy arrearages) or to vacate the premises in the case of a month-to-month tenancy, all other things being equal.

2. Provide for the recapture of tenant concessions. The lease should include clauses providing that, in the event of a default, the tenant must immediately reimburse the landlord for all "free rent", tenant improvements and other concessions. Although such a provision will have little practical benefit in many insolvency cases, provisions of this type may generate surprising and substantial benefits in some cases. In a recent case, we obtained more than \$50,000 for a landlord - amounting to about half the liquidated proceeds of the assets of the bankruptcy estate - the enforcing these types of clauses.

Default and Enforcement:

1. Negotiate a surrender of the premises. Much of the landlord's damages, as identified above are derived from costs and delays associated with attempting to regain possession of the premises. Often a landlord can convince the tenant to agree to surrender possession of the premises and to execute an agreement terminating the lease, thereby eliminating all of those damages. Most large landlords should have termination of lease agreements (with appropriate release language) on their word processors.

2. Enforce the lease quickly. Although the expense and delays associated with the unlawful detainer action are unattractive, until the landlord commences an unlawful detainer action, the defaulting tenant has no incentive to comply with the lease. If the tenant responds to the action by performing under the lease (or choose to "assume" the lease in a subsequent bankruptcy case), all the landlord's expenses should be recoverable under any well-drafted attorneys' fees clause. Until the landlord enforces the lease through an unlawful detainer action, however, the tenant can enjoy the rent-free use of the premises indefinitely and the

landlord's losses will continue to grow.

3. Encourage the tenant to file bankruptcy. In a bankruptcy case, the landlord's power is dramatically greater, the likelihood of receiving post-bankruptcy rent payments is dramatically higher, the process of regaining possession of the premises (or a cure of the lease) is much quicker and attorneys' fees will generally be much lower. Provided the landlord promptly retains insolvency counsel to enforce its rights, it is far better off if the defaulting tenant is subject to a bankruptcy case.

The principal focus of a landlord's reaction to a tenant who is in default under its lease must be practicality. Since the principal damage suffered by the landlord is the inability to derive revenue from the premises, the landlord must act quickly and firmly to regain control of the premises.

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