Leasing After COVID, Part II: Tenant Security
By Ann E. Ryan and Adrienne B. Koch

The pandemic has highlighted vulnerabilities in two of the most popular forms of tenant security—guaranties and security deposits. In Part 2 of their series "Leasing After COVID," Ann Ryan and Adrienne Koch examine the impact of the pandemic on each of those types of security and offer some suggestions for landlords going forward.

By Ann E. Ryan and Adrienne B. Koch (September 7, 2021)

Ensuring that a tenant's obligations under a commercial lease are adequately secured has always been an important part of the leasing process. Without proper security, many of the remedies in a lease may not be worth the paper they are written on: if the tenant's coffers are empty, security may be the landlord's only financial recourse.

The COVID-19 pandemic underscored the importance of security. Huge numbers of tenants defaulted on their rent payments, while eviction moratoria left landlords with few remedies. Landlords who were well-secured had a distinct advantage.

The pandemic also highlighted vulnerabilities in two of the most popular forms of tenant security—guaranties and cash security deposits. This article (the second in a three-part series) examines the impact of the pandemic on each of those types of security and offers some suggestions for landlords going forward.

Many commercial leases are secured, in whole or in part, by a guaranty, which is an agreement by another person or entity to be responsible for all or some of the tenant's obligations under the lease if the tenant fails to perform. Guaranties can be appealing to both sides. From the tenant's perspective the upfront costs are low, as a guaranty does not tie up needed cash the way a security deposit does.

For landlords, a guarantor is not only someone who can be pursued in the event the tenant defaults or files for bankruptcy, but may also be an ally on the tenant side of the lease. A guarantor has a vested interest in the tenant's continued compliance with its lease obligations.

Even before COVID-19, however, guaranties were not a panacea. Not every tenant can (or is willing to) produce a guarantor. Additionally, landlords often have to engage in costly litigation to actually collect from a guarantor, and enforcement can be frustrated by the guarantor's own financial situation.

The COVID-19 crisis added another complication: by local law, the New York City Council suspended the enforcement of certain personal guaranties. (SeeNew York City Local Law 2020/055, as modified by New York City Local Law 2020/098 and 2021/050). The suspension "only applie[d] when the guarantor is a natural person other than the tenant," and initially "only cover[ed] payments due between March 2020 and March 2021" (although it was later extended through June 30, 2021—see New York City Local Law 2021/050); however, "its effects are permanent: the landlord may never collect from the personal guarantor for those payments." See *Melendez v. City of New York*, 503 F. Supp.3d 13, 18 (S.D.N.Y. 2020) (emphasis added).

This legislation was challenged as a violation of the Contracts Clause of the U.S. Constitution, but it has so far been upheld based on a finding that, although it does "impose a substantial impairment" on contract rights, it is "reasonable and necessary" to advance a "legitimate public interest." Id. at 31-36.

This ruling is currently on appeal. If it is affirmed, it could have significant implications for guaranties going forward. While the suspension is now in the past and the COVID-19 pandemic presented extraordinary circumstances, the possibility that the legislature could simply take away the protection of a lease guaranty is a factor that landlords must now consider when negotiating lease security.

Cash security deposits, which are usually made at the outset of a lease and held in a segregated account pursuant to NY GOL §7-103, offered certain advantages during the COVID-19 pandemic. Many landlords and tenants agreed to use them to provide much-needed cash flow to cover tenant obligations. Landlords may therefore be tempted to rely more heavily on this method of security, particularly in light of some of their experiences with guaranties. But cash security deposits present difficulties as well.

For one thing, money is still tight for many businesses. This may mean that fewer tenants are in a position to tie up the cash needed for a security deposit, rendering this option unavailable as a practical matter.

Perhaps even more significantly, if a tenant files for bankruptcy a cash security deposit is considered part of the debtor's estate. The landlord cannot apply it without permission from the bankruptcy court. This can make these funds either unavailable or difficult and/or expensive to access when the landlord needs them most.

It is more important than ever for landlords to maximize the benefit of every security vehicle they are able to negotiate. Counsel representing landlords should consider taking the following steps to protect their clients:

- **Keep an eye on entity roulette and financial information.** Make sure that your client has reviewed, and is comfortable with, financial information for the actual tenant and guarantor (if any). If the entities named in the final documents have changed since the letter of intent, additional security may be required. Consider requiring the tenant and/or any guarantor to provide annual financial statements, and reserve the right to require additional security if their financial status declines beyond a certain point.

- **Watch entity changes throughout the lease term.** Ensure either that any guaranty will stay in place following any assignment of the tenant's interest in the lease, or that the assignee will provide a suitable replacement. Absent careful drafting, a change in the identity of the primary obligor may give rise to a defense against liability on the guaranty. Also, if the lease permits the tenant to assign its interest in the lease to a related entity, such as a successor by merger or similar corporate event, without the landlord's consent, make sure that such right is conditioned on the assignee having a net worth that: (i) meets an objective threshold, such as a multiple of the then-current annual rent or a set dollar amount; or (ii) is equal to or greater than the greater of the original tenant's or original guarantor's net worth (depending on which party is the "credit" entity under the lease, and whether the guarantor is being replaced) as of

(x) the date of the lease or (y) immediately preceding the date of the transfer. Try to ensure that any reduction in the creditworthiness of the tenant will be offset by an increase in that of the guarantor, or by other security.

- **Consider a letter of credit.** In lieu of a security deposit, many landlords require tenants to obtain an irrevocable standby letter of credit. Unlike a cash security deposit, a letter of credit is an independent obligation of the issuing bank to the landlord rather than an asset of the tenant. As a result, it can be applied in most cases after the tenant files for bankruptcy. Ensure that: (i) the issuing bank is a creditworthy institution; (ii) the final expiration date of the letter of credit extends at least a month or two beyond the expiration date of the lease, in case of any holdover or damage to the premises; and (iii) the form of sight draft or draw request does not require the landlord to state that the tenant is in default beyond any notice and cure period under the lease, as a tenant bankruptcy will bar the landlord from serving default notices. If the tenant or landlord entity changes or the landlord relocates during the term, make sure that any letter of credit is updated and remains current. Failure to do so could complicate the landlord's ability to draw down on the letter of credit or, in the case of a change of the landlord's address, cause the landlord to miss an important notice of non-renewal. COVID-19 office closures also highlighted the advantages of being able to make a draw request by fax or email; try to negotiate this into the letter of credit whenever possible.

- **Know your guarantor.** Landlords should periodically confirm that any individual guarantor is still associated with the tenant, and that they have the correct current contact information. If the guarantor is an entity, the landlord should periodically make sure that the guarantor continues to exist and is in good standing. Require the guarantor to acknowledge and execute any amendments or modifications to the lease, particularly those that increase the tenant's obligations.

The COVID-19 pandemic tested the strength of the mechanisms landlords commonly use to secure tenant obligations. Some of them failed in ways that could not have been anticipated. But that collective experience has also shown how those mechanisms can be improved going forward—not only to protect against the (hopefully unlikely) event of another similar catastrophe, but also to provide greater security against more common events.

By taking those lessons into account, landlords and the attorneys who advise them can make it more likely that the tenant security they put in place will actually be there when it is needed.

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