

March 9, 2009

Tenant Bankruptcy Can Result in Loss of Landlord's Security

Landlords should be aware that, under current bankruptcy law, a tenant's bankruptcy may limit the amount of a security deposit that is available to a landlord if a tenant rejects a lease. It is possible, however, to minimize the risk of loss, at least in some circumstances, through careful structuring of security devices.

Risk to Landlord

A tenant's bankruptcy may require even the diligent landlord to return a portion of its security deposit to the bankruptcy estate.

The Bankruptcy Code caps the amount that a landlord can recover from a tenant after that tenant's rejection of an unexpired lease in bankruptcy. The cap applies to a proof of claim filed by the landlord, the debtor or trustee on behalf of the landlord, or that is deemed to be filed under the Bankruptcy Code, and the cap limits a landlord's recovery to only a portion of the rent to which the landlord otherwise might be entitled. A security deposit may, or may not, help cover amounts that exceed the cap.

The Cap Briefly Explained

The amount of the cap is based on the rent remaining to be paid under the lease for the greater of (i) one year or (ii) 15% of the term of the lease remaining after the earlier of the bankruptcy filing date or the landlord's recovery of the leased property (by repossession or tenant's surrender), but not more than 3 years. The cap does not prevent recovery of rent accrued as of the earlier of tenant's filing or landlord's recovery of the leased property (and at least one court has held that it does not apply to reduce a landlord's recovery against a debtor/tenant for waste, nuisance, and trespass arising from failure to remove mining debris and equipment from the leased property).

Security Deposits in Excess of Cap

Bankruptcy law requires a landlord to return to the tenant's bankruptcy estate the amount by which a *cash* security deposit exceeds the landlord's recovery cap, especially when the tenant's funds were used to make the security deposit. The landlord's position can be improved if the security deposit is made in the form of a letter of credit or with funds belonging to one not the tenant, such as a guarantor.

Possible Solutions

- **Guaranty:** If the guarantor is not a debtor in bankruptcy, then the Bankruptcy Code does not prevent the landlord from proceeding against the guarantor for the full amount of landlord's actual damages. Landlords, however, must keep in mind that, if a guarantor has filed for bankruptcy, a landlord's recovery from the guarantor will also be limited by the Bankruptcy Code. Further, the possibilities that the bankruptcy court might enjoin enforcement of a guaranty or that the landlord will be forced to pursue enforcement litigation can make third party guaranties challenging to enforce against even a solvent guarantor.

- **Letter of Credit:** A tenant's bankruptcy filing does not affect the right of a landlord to draw on a letter of credit of which it is a beneficiary. However, there is a risk of loss associated with proceeds drawn from the letter of credit. Certain courts have interpreted the Bankruptcy Code to require the return of "excess" proceeds (i.e., above the rent recovery cap) of that letter of credit. The 5th Circuit has permitted full recovery to the landlord in certain circumstances (no proof of claim filed – hard to know how broadly to read that decision, though the court intimated that its position might be the same even if a proof of claim were filed). (VIP Note: This analysis addresses only the relative benefit of a letter of credit as a security deposit in the case of a tenant's bankruptcy. Other factors to take into account when considering use of a letter of credit include the (i) creditworthiness of the issuing bank; (ii) potential risk of misplacing the letter of credit; (iii) failure of property management to monitor expiration of the letter of credit; and (iv) various other complications upon sale or finance of the property.)

Conclusion

Given the current state of the economy, landlords looking to obtain credit enhancements from their tenants should consider the effects that a tenant's bankruptcy might have on the value of those enhancements. In particular, a landlord who is negotiating a new or amended lease must be aware of the possible effect that a tenant's bankruptcy may have on the security deposit under the lease. The type and source of the deposit may be important to a landlord's being able to fully realize its value.

If you have any questions, please contact us to discuss landlord protection issues in more detail. Also, Haynes and Boone, LLP, can work with you to structure security devices that are designed to better protect your particular business needs.

[Robert S. Ladd](#)

713.547.2023

robert.ladd@haynesboone.com

[Robert A. McCulloch](#)

214.651.5600

robert.mcculloch@haynesboone.com

[Ann M. Saegert](#)

972.739.8632

ann.saegert@haynesboone.com

[Steven A. Waters](#)

210.978.7406

steve.waters@haynesboone.com