Protections Against the Abandonment of Initial Improvement Work Where a Construction Allowance is Provided to a Tenant with Questionable Creditworthiness

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Landlords seeking to mitigate the risk of being left with an incomplete project financed in whole or in part with its own funds will resort to a variety of techniques to protect its investment. This article will explore such protections and highlight certain advantages and disadvantages of each from both the landlord and tenant's perspective.

In order to attract certain tenants, it is common for commercial landlords to pay for some or all of the costs of preparing the prospective tenant's space for its initial occupancy. The landlord will typically view such an improvement "allowance" as a financing arrangement, the cost of which will be amortized over the term of the lease and added to the rental rate that would otherwise be charged for the space. By doing so, the landlord anticipates that it will recoup its upfront costs through the tenant's regular rental payments throughout the lease term.

In order to determine the tenant's ability to meet the financial obligations of the lease, and, therefore, the landlord's ability to recoup its contribution to the initial build-out, the landlord will conduct financial diligence on the prospective tenant and assess the long-term viability of the business. However, when a landlord considers providing an improvement allowance to a tenant with questionable short-term creditworthiness, there is an additional concern that the tenant will not finish the build-out and surrender the space in an incomplete condition. Therefore, landlords seeking to mitigate the risk of being left with an incomplete project financed in whole or in part with its own funds will resort to a variety of techniques to protect its investment. This article will explore such protections and highlight certain advantages and disadvantages of each from both the landlord and tenant's perspective.

Timing of Allowance Payments

Given the choice, a tenant would prefer to submit bills from its contractors and vendors to the landlord and either have the landlord pay the bills directly or pay the applicable portion of the tenant improvement allowance to the tenant for it to then pay the contrac-

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tors and vendors. In such cases, the tenant uses the landlord's money to pay the current bills and does not have to expend its own funds so long as the allowance is not exhausted. However, if the landlord distributes the allowance as the bills come due, the landlord exposes itself to the risk that the tenant will not complete the work or ever open for business. Therefore, a landlord's best strategy is to pay the allowance only after the tenant has completed the initial improvements and has opened for business. Although this strategy is less advantageous for the tenant from a cash flow perspective, it protects the landlord against a tenant abandoning the project that the landlord has already financed in whole or in part. Obviously, this strategy also enables the landlord to retain its money for a longer period of time, thereby avoiding any lost opportunity costs.

If a tenant has enough leverage and refuses landlord's proposal to withhold the allowance until the work is complete, the parties might compromise and agree to a modified version of "progress payments" instead. That is, instead of paying the bills as they become due, the landlord might agree to reimburse the tenant for the bills paid once certain milestones are achieved (i.e., as the work progresses). For example, the landlord might agree to reimburse its tenant for half of the allowance once half of the work is complete and the remainder once the tenant is open for business. Alternatively, the landlord might agree to reimburse the tenant for a third of the allowance once a third of the work is complete, an additional third once two-thirds of the work is complete and the final third of the allowance once the tenant is open for business. Obviously, this payment schedule is not ideal from the tenant's perspective since they are required to pay out-of-pocket for the bills as they become due. On the other hand, they do not have to wait to be reimbursed for those costs until the build-out is complete. Likewise, from the landlord's perspective, this payment schedule is less than ideal since the allowance funds provided to the tenant remain subject to the risk that the tenant will abandon the project. On the other hand, the tenant is invested in the project and prior to landlord's progress payment, has its own money at risk. If the tenant were to abandon the project prior to a certain milestone, the landlord would have no obligation to reimburse the tenant for any money the tenant spent since the last progress payment, thereby protecting part of the allowance funds from being invested in a project that may or may not be completed.

Where the tenant improvement allowance is only a portion of the overall build-out cost, a typical compromise is for the landlord to distribute the allowance on a *parri passu* basis. This means that the landlord pays a fraction of the periodic (usually monthly) payment request (for completed work) which fraction is determined by dividing the amount of the entire tenant improvement allowance by the estimated cost of the build-out. For example, if the entire tenant improvement allowance was $25,000 and the estimated cost of the build-out was $100,000, the landlord would pay one-quarter of each periodic payment request. Allowance payments made on a *parri passu* basis are generally viewed as an equitable solution when the project is estimated to cost more than the allowance, since each party contributes its share of the cost at each stage of the project. That is, payments made on a *parri passu* basis ensures that neither party is ever burdened by paying for more than its share of the overall costs of the project.

Security for Performance of Obligations

In order to secure a tenant's obligations under the lease, including the tenant's obligation to fund its portion of the initial improvements and complete the initial build-out, landlords will, typically, either insist on a cash security deposit or a letter of credit and/or a guaranty from a creditworthy individual or entity.

Cash Security Deposit

Cash security deposits are the easiest of the above options to establish and collect from, given that the funds are held and controlled by the landlord. The utility of the cash security, however, may be limited if the tenant files for bankruptcy, since the security deposit may be considered property of the tenant's bankruptcy estate. In fact, if the lease is rejected in the tenant's bankruptcy case, the landlord will not be permitted to apply the security deposit to the full amount of damages sustained by the landlord as a result of the rejection, but, rather, only to the limited damages that the landlord is permitted to claim against the tenant under Bankruptcy Code Section 502(b)(6). Under that Section, a landlord's damages recoverable from a bankrupt tenant will be limited to (i) the remaining rent under the lease, limited to the greater of one year, or 15% of the remaining rent, not to exceed three years, calculated from the earlier of the petition date or the date the landlord regained possession of the property, plus (ii) unpaid rent which had accrued prior to the bankruptcy filing. Due to this statutory limitation, the landlord is required to return to the tenant's bankruptcy estate the amount of the tenant's security deposit that is in excess of the landlord's capped damages. Thus, to the extent Section 502(b)(6) of the Bankruptcy Code is applicable to the tenant's unpaid improvement costs, this statutory cap creates uncertainty that the security will be collectible in the event the tenant fails to fund all or part of its portion of the initial improvements and then files for bankruptcy.

Letters of Credit

As an alternative to the cash security deposit, landlords will often require tenants to post a security deposit in the form of an irrevocable, standby letter of credit. A letter of credit is an instrument in which the issuing bank (in this case, tenant's bank) agrees to honor a demand for payment made by a third party (in this case, the landlord) up to the amount of the instrument so long as the demand complies with the stated conditions. The effect of a letter of credit is to substitute the creditworthiness of the issuing bank for that of its customer (in this case, the tenant). Unlike the cash security deposit, the letter of credit and the proceeds of any draw thereon have traditionally been considered not to be the property of the tenant's bankruptcy estate. The long held rationale has been that letters of credit are governed by the "independence principle" that considers the relationship between the bank and the landlord to be independent from the relationship between the tenant and the landlord. Based on this principle, a landlord may draw down on the letter of credit if the tenant files for bankruptcy. Before taking such action, or other actions that may be said to be an act of collection in connection with any draw, however, it is best to obtain the advice of counsel. Although courts have not provided uniform guidance, it has been held, despite the independence principle, that draws on letters of credit may nonetheless reduce the statutory cap on rejection damages imposed under Section 502(b)(6). Accordingly, to the extent Section 502(b)(6) of the Bankruptcy Code is applicable to the tenant's unpaid improvement costs, the statutory cap may limit a landlord's ability to collect unpaid amounts. Thus, although the letter of credit is generally viewed as an enhanced form of security relative to a cash security deposit, the protections afforded with respect to recovery of unpaid improvement allowances may depend upon the circumstances and the reasoning followed by the court.

Tenants, however, may assert some level of control over the amounts they provide a landlord as security, whether in the form of a cash security deposit or a letter of credit, by insisting that the original amounts thereof reduce, or "burn off," in whole or in part when certain conditions are satisfied. Where a tenant has agreed to pay for part of the initial improvements, the tenant might insist that the security amount should be reduced at certain milestones to reflect the tenant's partial fulfillment of its obligation to fund the improvements. For example, the tenant might insist that if the landlord has agreed to distribute the tenant improvement allowance on a *parri passu* basis and the work is half complete, half of the security held by the landlord to secure the tenant's obligation to fund its portion of the improvement costs should be returned (or in the case of a letter of credit, the letter of credit should be amended to reduce the original amount by half). If a landlord agrees to such a "burn off" or "burn down" of the security, a tenant is able to recover a portion of the funds set-aside to secure its funding obligation as it fulfills its obligations, instead of having to wait until the project is complete before the entire amount is returned.

Guaranties

One of the most effective ways to secure a tenant's obligations under the lease, generally, is to obtain a guaranty from a creditworthy individual or entity. Even if the landlord does not require the tenant to provide a guaranty to secure all of the its obligations under the lease (i.e., one that remains in effect during the entire term of the lease), a landlord might insist on a limited guaranty to secure a tenant's obligations to fund its portion of the initial improvements and, in certain instances, complete the initial build-out. Depending on the creditworthiness of the tenant, a landlord may even insist on a guaranty in addition to a cash security deposit or letter of credit. The purpose of a guaranty is to provide an additional source of recourse (i.e., the guarantor) in the event the tenant fails to fulfill its obligations under the lease. In addition to providing an additional source of security to the landlord, the guarantor may also be a source of additional pressure on the tenant to ensure that the tenant performs its lease obligations.

A landlord seeking to secure the tenant's obligation to fund its portion of the initial improvements as well as the completion of the build-out might insist on a payment and performance guaranty. Under the payment and performance guaranty, the guarantor agrees not only to cure the monetary default, but also to perform all of the other defaulted obligations under the lease. That is, where the guaranty is limited to the tenant's obligations during the initial build-out period, if the tenant abandoned the project prior to the completion thereof, the guarantor would be obligated to fund the tenant's portion of the improvements costs as well as complete the project. A guarantor, however, might try to limit the guaranty to a payment guaranty only (and not a performance guaranty) so that it would only be obligated to cure the monetary default. Understandably, guarantors would prefer avoiding the additional obligation of having to complete a build-out in the event the tenant abandoned the project. A landlord seeking the strongest guaranty might also insist that it be a guaranty of payment as well as a guaranty of collection. With a guaranty of payment, upon a tenant's monetary default, the landlord is not required to pursue the tenant first before proceeding against the guarantor. If the guaranty is of collection only, the landlord must attempt to collect the payment from the tenant and exhaust its remedies against the tenant before it may pursue the guarantor. Therefore, a landlord seeking the maximum protection against a tenant abandoning the initial build-out project would typically insist on a payment and performance guaranty that guarantees both payment as well as collection.

Bonds

Landlords seeking to mitigate the risk of a tenant abandoning the initial build-out will, sometimes, insist that the prospective tenant obtain a payment and/or performance bond. The conventional thinking among such landlords is that, if the tenant fails to complete the project, the surety will, somehow, guaranty its completion. The request alone highlights a widely held misunderstanding in the landlord/tenant community regarding how payment and performance bonds function, as neither bond provides any meaningful protection against a tenant who abandons its initial build-out.

Performance bonds guarantee the person who hires the contractor (the "owner") that the *contractor* will complete the construction contract according to its terms, including price and time. That is, the performance bond protects the *owner/tenant* from financial loss if the *contractor* fails to perform and meet the terms and conditions of the contract by providing a financially responsible party to stand behind the contractor's obligations. If the contractor defaults, or is terminated for default by the owner/tenant, the owner/tenant may call upon the surety to complete the contract. Not only does the performance bond provide security to the owner/tenant that the work will be completed if the contractor fails to perform under the construction contract, but it also provides assurance that the contractor is qualified and able to complete the applicable work. These bonds are issued on the basis of careful analysis and evaluation of the contractor's abilities to perform its obligations under the construction contract and, therefore, serve as a reliable means of vetting the potential contractor's abilities as well.

In contrast, payment bonds guarantee the owner/tenant that the subcontractors and suppliers will be paid the monies they are due from the contractor. If the contractor fails to so pay subcontractors or suppliers, either the owner/tenant or the affected subcontractor or supplier may sue on the bond and receive the unpaid monies. An owner/tenant benefits indirectly from a payment bond in that the subcontractors and suppliers are assured payment and will, likely, continue working through their problems with the contractor knowing that they are assured payment. There is some indirect benefit to a landlord (who is not a beneficiary of the bond) as well since the payment bond provides the subcontractors and suppliers a remedy in place of a mechanics' lien, which, if placed on the property, could adversely affect the landlord's title to its property.

As the foregoing demonstrates, payment and performance bonds are effective tools for protecting against a contractor's default and its failure to pay subcontractors and suppliers. Contrary to the view held by some landlords, however, they do not provide meaningful protection against a tenant abandoning its build-out and, therefore, should not be relied upon as a means of mitigating such risks.

Conclusion

As long as landlords continue to provide improvement allowances to tenants with less than ideal creditworthiness, the risk of having these funds invested in a project that is eventually abandoned will continue to exist. Although there is no way to completely eliminate this risk, there are a number of protections that can be implemented to mitigate it—some more effective than others. Given the advantages and disadvantages of each type of protection, it is imperative that counsel representing the landlord providing the allowance, as well as the lawyer representing the tenant accepting the same, have a firm understanding of the strengths and weaknesses of each protection. Without a nuanced appreciation for the differences among them, a landlord runs the risk of contributing greater amounts of its funds to a project that may not be completed and/or have no one to perform the obligations should the tenant abandon the project. Similarly, a tenant who does not understand how the various protections vary may find itself providing the landlord with greater assurances than it initially intended to. As in most transactions, leverage of the parties will, likely, dictate the mix of protections that are ultimately agreed to, but understanding how each protection functions should place each party in the best position possible to advocate for its respective interests.