

# Current Issues Facing Landlords, Tenants and Subtenants

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In today's uncertain times, landlords, tenants and subtenants are all facing issues arising out of their leases and subleases that many if not most of them have had to face since perhaps the last downturn in the economy. This article highlights a few of the issues that should be considered or could be overlooked by landlords and their property managers or by tenants and subtenants as they pursue modifications to existing leases or new leases and subleases. While not exhaustive by any means, it does address some of the issues that are of greater importance today more so than during boom times.

## **Issues Facing Landlord**

### **Responding to Requests by Tenants for Concessions**

Today tenants are requesting rent relief and other concessions as they feel economic pressure on their businesses or sense an opportunity to gain an advantage over their landlords who may be facing rising vacancies and the need to refinance. When approached by a tenant seeking relief, the landlord needs to first assess the financial impact of the request on the project and its short and long-term prospects and whether it anticipates it will have to finance or refinance the building in the near future.

At a minimum, landlord should:

- Ask whether the requested relief will just “kick the can” down the road (i.e., extend the problem out), or does the tenant have a bona fide chance of surviving or thriving as an important tenant for the project if it is provided some temporary relief? Alternatively, does the tenant really need the relief, or is it simply fishing to see what it can get? The answer to these questions may end the discussion with the tenant regarding any relief – temporary or otherwise.
- To better assess whether the tenant has a legitimate basis for the request, ask the tenant for current financials and/or comparisons to prior year financials if the landlord has not previously received them or review the ones that were provided by the tenant to see what can be gleaned about the tenant's financial status. For retail tenants, require a comparison of same store sales for the prior year or two as compared to the current year. Assess the tenant's credit before deciding – if the tenant is on the verge of bankruptcy, it may not pay to agree to any concessions on rent (see discussion below on what happens when a tenant files for bankruptcy).
- Review your current loan documents to determine whether the lender's consent is required to any modification. If lender consent is required, what must the landlord provide to the lender as part of the consent process and when during the process? Make sure you obtain all required documentation from the tenant.
- Avoid having multiple persons in your office deal with the tenant. This is important to avoid the risk of someone making oral promises or representations that can later be used against the landlord.

- Have the tenant sign a confidentiality agreement prohibiting it from telling other tenants about the relief it sought and received as a condition of entering into negotiations. The agreement should include penalties for a breach (e.g., reinstatement of the prior rent).
- Review the entire lease file before responding to any request to see if there are any other issues the landlord would like to “tidy up” as part of any amendment or modification. For example consider:
  - Should options to renew, extend or expand be eliminated? Or, should the tenant be required to extend its lease term as part of the modification. Which makes better sense financially for the landlord? The answer may depend on when the tenant’s current lease term is scheduled to expire and what the landlord thinks the likely rental market will be at that time.
  - Will reduced or abated rent bounce back at some defined point in the future, or only if the tenant defaults while under the new arrangement? Will the amount of the rent abated or reduced be recovered in the form of higher rent in the future or only if the tenant defaults in the payment of the reduced rent or files for bankruptcy?
  - Should the landlord obtain personal or parent company guarantees where there were none before?
  - Should the tenant provide a security deposit if the tenant had not previously provided one or increase the amount of its current security deposit?
  - Does the tenant owe the landlord any payments (e.g., percentage rent, CAM or operating and tax adjustments) or other documents (e.g., current proof of insurance)? If so, require the missing information or payments be made as part of the modification.
- For a retail tenants asking to go to rent equal to a percentage of actual sales only or minimal fixed rent with a higher percentage of sales, the following should be considered:
  - Require the tenant to prove it has actually experienced a decline in sales revenue during the prior 12-18 months at the particular store the landlord is leasing to the tenant. This will flush out those asking just to see what they can get. If in store sales at the landlord’s location have remained steady or even increased, the landlord can use this information to deny the request for relief and to promote the attractiveness of its location compared to other locations where the general downturn in the economy may have impacted your tenant’s business adversely.
  - Consider allowing temporary relief only until the tenant’s sales reach a certain specified level, after which rent will revert to the amount prior to the modification.
  - Consider adding relief for the landlord from onerous co-tenancy restrictions and/or establish tighter prohibitions on the tenant going dark.

- Consider loosening up prohibitions on co-tenants going dark.
- Consider adding a radius restriction for new stores if the lease did not contain any.

### **Act Quickly If a Tenant is In Default**

As soon as a tenant defaults in the payment of rent or in some other way, the landlord and its property manager should review the tenant's lease and lease file to identify all defaults. Notices of default should be sent out promptly to start any cure periods running. Asking a lawyer for help at this stage may speed up the process if there is ultimately a need to evict the tenant because careless errors in giving notices may require new notices, which means delay.

As soon as all notices of default have been sent and all applicable cure periods have run without cure, the landlord should apply any security deposits held by the landlord promptly to any unpaid rent and demand the deposit be replenished. The application of security deposits to unpaid rent may become critical if the landlord believes the tenant is likely to file for bankruptcy. According to a Northern Illinois District bankruptcy case, the trustee for a Chapter 7 could not require the debtor's tenant's landlord to turn over a security deposit when the landlord had already exercised a right of setoff prior to the tenant's filing a petition in bankruptcy unless there was some evidence that the landlord lacked the authority to effectuate the setoff. According to the court, as of the commencement of the bankruptcy case, the debtor no longer had any interest in a security deposit that the landlord had already lawfully set off in partial satisfaction of the tenant's obligations under its lease.

However, applying a cash security deposit is not much help to correct a landlord's cash flow problems unless the landlord holds segregated security deposits in an account and hasn't already spent them. If the landlord holds a letter of credit as a security deposit, within 10 days draw on the letter of credit and applying the proceeds to pay all rent arrearages. If the lease is dated properly, any remaining cash not applied can be held as a security deposit and applied to each new amount coming due that is not paid as long as the tenant has not filed for bankruptcy.

Once all cure periods have run without cure by the tenant, the landlord or property manager should ask the landlord's lawyer to send the proper statutory notices – either a 10-day notice to quit under which the tenant is immediately notified its lease is terminated and it must vacate the premises within that 10-day period of time or a 5-day notice demanding full payment of all arrearages within that 5-day period or the lease will be terminated. Assuming the tenant does not cure the default, file a forcible entry and detainer action to evict the tenant. The statutory notice provisions in Illinois contain very technical requirements. If the notice does not include the correct name of tenant, the correct address for the tenant or the correct number of days, or if a proper method of service is not used will give the tenant's attorney an opportunity to object to the eviction proceedings, and the judge may dismiss them and the landlord will have to start over.

Consider terminating the lease rather than simply the tenant's right to possession – an option most commercial leases allow the landlord. If the lease has been terminated before the tenant files a petition for relief under the Bankruptcy Code, or if the landlord has obtained a judgment for

possession prior to the tenant's filing for bankruptcy, the lease will not be an asset of the bankrupt tenant's estate. This means the automatic stay and the tenant's right to assume or reject the lease under the Bankruptcy Code will not apply and the landlord will be entitled to immediately market the space.

### **What If a Tenant Vacates Its Premises Leaving Personal Property Behind?**

The most frequently asked question in the situation where a tenant abandons the premises yet leaves personal property and equipment behind is whether a forcible entry and detainer action must still be filed? The answer is "Yes." Self-help by the landlord changing the locks is not advisable or permitted by law – a court order of possession in favor of the Landlord is still required.

However, when the tenant leaves personal property, the landlord can combine the forcible entry and detainer action with an action called "distress for rent" or "Distraint." In Illinois, this statutory procedure can be used as means to satisfy all or part of a judgment against the tenant for unpaid rent and other amounts due to the landlord, but it is not a self-help remedy. The statute allows the landlord to secure the personal property left behind by the tenant for a later sale, but only after filing a distress warrant in the circuit court of the county in which the property is located. The warrant must include a complete inventory of the property, and the landlord must obtain a judgment against the tenant for the amount due. However, once the distress warrant is filed, the tenant cannot remove the property without posting a bond equal to two times the unpaid rent claimed payable to the landlord.

The landlord should also research whether there are any possible UCC financing statements on equipment and personal property the tenant left behind and give a notice of the proceeding to any secured creditors. Any equipment financier would have priority over the landlord. If there are none, however, the distraint procedure allows the landlord to ultimately sell the tenant's property to satisfy its judgment against the tenant. There is one possible means provided for under the statute that allows the landlord to conduct a quick sale of the tenant's property prior to obtaining a judgment against the tenant – that option is available if any of the property of the tenant is perishable. In those cases, the landlord can ask for an order allowing for an immediate sale before judgment, but the landlord must then deposit the proceeds with the clerk of the court until it obtains a judgment.

### **Landlord's Duty to Mitigate Damages**

By statute in Illinois, a landlord must mitigate its damages following a default by its tenant. This means the landlord must take reasonable efforts to re-lease the premises, and if the landlord fails to do so, it will not be entitled to collect the entire amount of the rent due from the original tenant.

The burden of proof that the landlord has mitigated its damages is on the landlord – not on the tenant. What constitute reasonable efforts to mitigate is very fact specific. At a minimum, the landlord must hire a broker to actively lease the space. The landlord does not have to actually lease the premises, but if it has not used reasonable efforts to do so, the amount of damages it may recover

from the tenant will be reduced by what the court believes is the fair market rental value of the premises.

### **What Happens if the Tenant Files for Bankruptcy?**

Upon the filing of a petition for bankruptcy, the Bankruptcy Code provides for an automatic stay. This means that no action may be taken by the landlord to terminate the lease, evict the tenant or collect amounts due the landlord. Instead, the landlord must file a petition for relief (with some basis for seeking relief) and obtain Bankruptcy Court approval.

A bankrupt tenant is automatically given 120 days to assume or reject the lease or to assume the lease and assign to a third party, unless it requests and is granted a 90-day extension by the bankruptcy court. The tenant must continue to pay the rent under the lease and otherwise perform its obligations under the lease during the time period from the date the petition is filed until the lease is either rejected or assumed, and if rent is not paid, the landlord can file a motion demanding payment or the right to evict the tenant.

If the tenant chooses to assume the lease, the tenant must cure all defaults, monetary and otherwise, and provide adequate assurance of future performance. If the tenant wants to assume and assign the lease to a third party, the third party must provide the landlord with adequate assurance of future performance. Typically, an assumption is allowed even if it violates the provisions of the anti-assumption language in the lease. The court will determine whether it is a reasonable business decision under the circumstances to approve the assignment. Under case law authority in the 7th Circuit in Illinois, an assignee of a shopping center lease must obey any use restriction clause in the lease. Other jurisdictions have held that requiring the assignee to conform to the use restrictions in the lease violates the right to assign provisions of the Bankruptcy Code.

If the tenant does nothing, the lease is considered rejected. If the tenant rejects the lease, the landlord is entitled to rejection damages equal to the greater of one year's rent reserved under the lease or 15% of the rent reserved under the lease for the remaining term, not to exceed three years of rent. Rent includes base rent and most additional rent (e.g., CAM or operating expense pass throughs and taxes). However, the obligations of a third party guarantor are not subject to the cap on the landlord's rejection damages if the lease is rejected. Unless the guarantor has also filed for bankruptcy when the tenant files, the landlord is free to pursue a guarantor during the automatic stay period. Thus, guarantees can be a significant benefit to landlords with defaulting bankrupt tenants.

Nevertheless, actions taken by a landlord to collect rent, modify a lease or obtain a lien on the property of a tenant as security for unpaid rent or other sums due the landlord within 90 days prior to the bankruptcy filing by the tenant (the "preference period") are subject to being undone. Thus, be cautious when dealing with a tenant that is on the verge of bankruptcy and seek the advice of a competent bankruptcy counsel before agreeing to any modifications to a lease.

### **What Form of a Security Deposit is Best - Cash or a Letters of Credit?**

Letters of credit generally are not considered assets of the estate of the bankrupt tenant, although it might depend on the law in the particular state where the property is located (some jurisdictions require landlords who draw on letters of credit to hold them in interest bearing accounts or limit the amount of security deposits allowed – if so, the proceeds might be held to be the asset of the bankrupt tenant). The landlord should be able to keep any cash security deposit if it is applied pre-petition to pay rent that is in arrears without regard to the cap on rejection damages under the Bankruptcy Code. However, most landlords spend the cash and do not segregate it. A cash security deposit, like prepaid rent, is property of the debtor's estate and may not be applied to the landlord's damages before the tenant rejects the lease, unless the court grants a lifting of the automatic stay. Any excess above the cap on the landlord's damages for rejection plus pre-petition arrearages must be returned to the debtor's estate unless it is used to pay amounts due after filing and prior to assumption or rejection of the lease. Thus, unless a cash security deposit has been held in escrow and is applied to pay rent before the tenant files for bankruptcy, a letter of credit is the best option for most landlords, particularly if the security deposit is a large amount and the amounts due from the tenant are equally as large.

### **Issues Facing Tenants**

#### **Payment for Tenant Improvements**

Any tenant entering into a new lease or an extension of an existing lease which calls for the landlord to fund tenant improvements has to wonder who will or can pay for those tenant improvements. Any creditworthy tenant ought to ask itself whether this is the time for it to commit to paying for its own tenant improvements in exchange for a lower rent during the lease term. If the tenant pays, it might be able to recoup some of its costs through tax credits for upgrades to lighting and other energy efficiency enhancements. There may also be grants for feasibility studies to determine what can be done to create a more energy efficient workplace. Cost segregation can be used to separately account for equipment from the real estate in order to depreciate it more rapidly. Depending on the tax position of the tenant, this might be attractive. However, unless a special incentive applies or the costs are associated with equipment depreciable over a shorter period of time can be separately determined under the tax code most real estate improvements must be depreciated over 39 years.

#### **The Importance of SNDAs**

Particularly where tenants are faced with uncertainty regarding the ability of their landlords to refinance a maturing loan on a building they are considering occupying, tenants need to insist on a subordination, non-disturbance and attornment agreements ("SNDAs) with their landlord's lenders. This is because if a mortgage is in place on a building prior to the tenant taking occupancy, it will have priority over a tenant's lease. Having priority over a lease means the lender will have the right to terminate the tenant's lease if it forecloses. Most of the time tenants occupying space in a building who are paying rent are an asset to a foreclosing lender, but if the tenant is paying a below market rental rate on its lease and the market has become a landlord's market by the time the lender

forecloses, it is possible a foreclosing lender will elect to terminate the tenant's lease. If so, the tenant needs to protect the value of its lease for itself by insisting that its lease be subordinate to a lender only if the lender agrees not to disturb the tenant's occupancy under its lease at the time it forecloses. In exchange, the tenant will need to agree to attorn to the lender or a purchaser at a foreclosure sale (i.e., recognize such party as its landlord) under the terms of its lease.

SNDA's are sometimes used by lenders as a means to amend the lease and for the lender to disavow any obligation to the tenant to cure landlord defaults or return security deposits. Providing a letter of credit as a security deposit is also a good option for tenants concerned about defaulting landlords whose lenders foreclose or who file for bankruptcy. The letter of credit can be reissued naming a successor landlord or foreclosing lender as the beneficiary instead of risking loss of the security deposit by the landlord's use of it and failure to pay it over to a successor landlord or foreclosing lender. Some lenders will agree in their SNDA's with tenants that they will be responsible for the tenant's security deposit. However, most will not agree to be responsible unless they receive it from the landlord.

#### **What If the Landlord Files for Bankruptcy?**

A tenant cannot do nothing if its landlord files for bankruptcy. Under the Bankruptcy Code a tenant has the right to remain in possession under the terms of a rejected lease, although the landlord has no obligation to fulfill any of its lease obligations after rejection. The tenant is entitled to offset the added costs it incurs as a result of the landlord's failure to perform against the rent it owes to the landlord.

However, another section of the Bankruptcy Code allows the court to order a sale of the debtor's assets "free and clear of any interest." One 7th Circuit case that tried to reconcile these two seemingly inconsistent provisions of the Bankruptcy Code held the property could be sold to the debtor's mortgage lender free and clear of the lease. According to the court Section 363 allows a sale "free and clear of any interest" in the property only if one of five conditions is met. One condition allows a sale if "applicable nonbankruptcy law permits sale of such property free and clear of such interest." According to the court, the tenant failed in its attempt to assert its right to remain in possession because the lease was unrecorded, and the parties did not dispute that the debtor's sale of the property free and clear of the lease was "authorized" and "permissible." Why the tenant's attorneys would make such a concession is unclear. The rationale could not be that a sale to a bona fide purchaser would extinguish the unrecorded lease, because from the facts in the case appears that the tenant was in possession both upon the filing of the bankruptcy petition and the closing of the sale. The premises were located in Indiana, and Indiana has a race-notice recording act, which means a bona fide purchaser cannot take free of an unrecorded lease when the tenant is in possession. Thus the case was an odd one, and there were many facts that might have led to the decision (including the fact that the tenant was only obligated to pay \$1 rent for the term of the lease), so it has been widely criticized. However, one significant fact is that the tenant failed to object at the hearing on the sale free and clear of its interests, which might in the end have been the real reason why it lost. The

bottom line holding by the court was that the ability of the debtor's trustee to sell assets free and clear trumped the tenant's right to remain in possession when the landlord rejected the tenant's lease.

Regardless of the facts in any situation where a tenant is faced with a landlord that has filed for bankruptcy, the tenant must be proactive and seek an acknowledgment of its rights under the Bankruptcy Code from the court.

### **Issues Facing Subtenants and Tenants in Subleases**

#### **Recognition Agreements**

Subtenants need to view subleases with a "buyer beware" attitude in these economic times. Even if the economics of the deals appear very attractive, the subtenant needs to weigh the cost savings from a sublease against the risk of a sublandlord/tenant default under the primary lease. The nature of a sublease is such that the subtenant has no direct contractual relationship with the landlord, which means that if the tenant defaults under its lease with the landlord or files for bankruptcy and the lease ends, the sublease ends automatically.

To avoid this problem, a subtenant should insist on a recognition agreement from the landlord, which an acknowledgment by the landlord that as long as the subtenant is not in default under the terms of its sublease, the landlord will allow it to remain in occupancy even after the tenant's lease ends, so long as the subtenant attorns to and recognizes the landlord as its landlord in place of the tenant.

The biggest issue in negotiating a recognition agreement is at what rent and on what other terms the subtenant's agreement with the landlord will be. Very few subtenants pay rent higher than that paid by the tenant, which means the Landlord will generally be unwilling to allow the subtenant to continue to pay the rent that it has been paying to the tenant. If the tenant's rent is above market, then the landlord will have even less incentive to compromise with the tenant on an agreement to pay fair market rent. With vacancy rates in all segments of the market reaching all time highs, Landlords may be more willing than in the past to accept a financially solvent subtenant at a rent somewhere in the middle, but it all depends on the landlord, the tenant and the subtenant.

A recognition agreement with a tenant's landlord does not, of course, address the landlord's lender, unless the lender also becomes a party to the recognition agreement, and agrees that if it forecloses it will also continue the subtenant's right to possession on the same terms as the landlord agreed to continue it following the tenant's default.

#### **What If the Tenant Files For Bankruptcy?**

Just as in the case of a tenant with a defaulting landlord, the subtenant must file its claim for rejection damages in the tenant's bankruptcy preventing. This is necessary so that if there is any distribution from the estate of the bankrupt tenant, the subtenant will be able to share on a pro rata basis with the other unsecured creditors. The amount of the claim will depend on the differential between the rent the subtenant has to pay to the landlord for a direct arrangement and the rent the subtenant was

obligated to pay under the sublease. Be prepared to document this differential in the recognition agreement with the landlord.

### **Protecting the Tenant from Defaulting Subtenants**

In order to avoid increasing its financial exposure under a lease, a sublandlord/tenant will typically want to prohibit the subtenant from exercising any of the tenant's options to expand, renew or extend the lease. Often a tenant becomes a sublandlord due to a desire to offload extra space or future expansion space. It wants to carefully control what the subtenant does (even if the subtenant becomes a direct tenant of the landlord) so as to minimize its obligations going forward or to maximize its own flexibility should it need the subleased space back. If a subtenant wants to remain in the space it subleases beyond the initial lease term, the sublandlord/tenant should insist the subtenant make a direct arrangement with the landlord if the tenant has determined it will not exercise any options to expand or renew.

During the term of the sublease the sublandlord/tenant needs to act like a landlord when the sublease is negotiated. That means at the first sign of trouble it needs to take swift action to terminate the sublease. (See discussion above on Landlord Issues.)

### **Conclusion**

Leasing issues are more complicated than ever when economic downturns occur. All of the parties involved will be adversely affected if another party defaults under its lease or sublease obligations. Being prepared and proactive are the key to protecting the interests of any party to the transaction.

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