Commercial Leasing Law IN Brief ™

How to Approach Late-paying Tenants

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Commercial landlords and property managers are surely aware of the revenue and cash-flow challenges that exist in today's commercial leasing market. Unfortunately, slow-paying, low-paying and, worse yet, no-paying tenants are more prevalent than ever. Simply put, times are tough. Though reasonable minds might differ as to whether our economy is still in a recession, most experts agree that landlords will continue to experience some degree of shortfalls in receivables into the foreseeable future. The purpose of this article is to provide landlords and property managers with a list of issues to think about once the cycle of slow-, low- or no-payment begins. Although not necessarily exhaustive, this list should serve as a useful guide from the time payment problems arise and, if necessary, through litigation and beyond.

It Begins... The Tenant's Payments are Late, Partial or Do Not Come.

Things happen, and a certain level of payment issues is to be expected. Landlords and property managers know, however, when lines are crossed and when payment issues become drains upon the bottom line and not just inconsequential annoyances.

1) The landlord's very first consideration when this occurs should be his or her degree of flexibility. Landlords might elect one of the following:
   a) A payment plan to bring the tenant current;
   b) A negotiated rent reduction; or
   c) A hard-lined approach that promises eviction if the tenant is not current by a date certain.

It goes without saying that some tenant spaces are more attractive than others, and that the first and most obvious consideration here is the estimated cost associated with finding a replacement tenant which includes, among other things, lost rent, commission, and costs to modify the space for a new tenant's needs. The landlord must also consider the indirect costs associated with a new vacancy. Will decreased traffic to the center affect the viability of other tenants? Do other leases in the center or your mortgage loan impose minimum occupancy requirements? Will the center become stigmatized, causing other tenants to seek alternative space? Will remaining tenants sense the landlord is in trouble and seek to renegotiate their own leases? How might a lowered occupancy percentage or spotty tenant payment history affect the future marketability of the space?

Flexibility by the landlord is not always appropriate or necessary, but does sometimes help maximize the long-term bottom line. And frankly, many leases were negotiated years ago

at rates that, by today's standards, exceed fair rental value. Regardless of what the landlord decides to do in this situation, two additional critical points must be remembered:

1) Agreements for payment plans or reduced rent must always be reduced to writing, and meaningful confidentiality clauses should be included. Tenants talk.
2) Where legal action is a possibility, always refer to the lease to ensure that the tenant is provided with all required notices of breach and any available opportunities to cure.
   a) Along these lines, beware the stale lease with an outdated address for notice (notice to the space itself may not always suffice). Keeping addresses up to date may also pay dividends if litigation or collection efforts become necessary.

It Has Become Apparent That The Tenant Cannot Pay. What Next?

1) Landlord's Absolute Cardinal Rule Number 1 – Have an objective, know what you want, and communicate with your attorney to accomplish your goals. To do this, landlords need to know their tenants.
   a) If your non-paying tenant is insolvent (which is usually the case), and if prospects for recovery on a personal guaranty are poor, getting quick possession without recouping rent may be the best case scenario. Once you've achieved possession, be careful not to spend additional money on litigation for an uncollectible judgment.
   b) If the tenant or, more likely, the personal guarantor might be solvent, pursuing a monetary settlement or judgment may be worth the time and expense.

2) Landlord's Absolute Cardinal Rule Number 2 – Leases differ, and the lease at issue is the law. It should frame all negotiations with the tenant.
   a) *Surrender* and *Termination* are different concepts.
      i) Surrender (prior to expiration of the lease) involves an agreement to restore the landlord's possession, but does not extinguish the tenant's obligation to pay rent *if the lease provides for continuing rent*. The landlord's possession is restored so that damages for lost rent may be mitigated through a new tenancy.
      ii) Termination is just that. The tenant's possessory rights and obligations under the lease are terminated, although the lease will usually call for payment of unpaid rent (either the accelerated unpaid amount, or an amount calculated by a formula – perhaps one that accounts for the landlord's duty to mitigate and/or discounts future damages to present value).
   b) These provisions vary from lease to lease, and will bear on whether the landlord chooses to pursue a surrender or termination.

3) What Lien Rights Has the Lease Afforded to the Landlord?
   a) Some retail leases vest the landlord with a security interest in the tenant's equipment and inventory as collateral for payment of rent.
      i) If a UCC financing statement was not filed to perfect the landlord's lien at the outset of the lease, the landlord should be thinking about whether to file once tenant payment troubles begin.

ii) Failure to file does not mean there is no security interest, but does mean that otherwise junior lienholders (i.e., vendors, contractors, etc.) may trump the landlord's security interest if they've filed to perfect their own lien(s).
iii) Keep in mind that purchase money lenders (i.e., the financier of the tenant's equipment and inventory) have a senior lien that has priority over all others, regardless of chronology.

b) Exercising Lien Rights
i) It is very important to conduct a UCC search to determine the existence of competing liens and the priority of those liens. It's also possible that the lease will require the tenant to disclose all known liens upon request.
ii) If the tenant owns its inventory and equipment free and clear, it may be possible to informally agree upon a manner of disposal to satisfy portions of the lease deficiency. Where no such agreement is possible, compliance with all UCC notice and procedural requirements is imperative before conducting any UCC sale.
iii) Where there are competing liens, most likely a purchase money interest held by a lender, the landlord should consider his preferred level of communication with that institution.
(1) Communication might help expedite clearing out the space to prepare for a new tenant.
(2) Communication might help provide the notice necessary to begin charging the lender rent for failure to promptly remove the equipment, or it may prompt the lender to begin paying for the landlord's warehousing of the equipment off-site. It might even lead to some agreement to release the lender's lien interest and to allow the equipment to remain in the space to, in turn, be leased or sold to a replacement tenant.
(3) Ultimately, the lender will probably have the right to auction the equipment, and landlords should be leery of on-site auctions that could stigmatize the center. The landlord may consider attending the auction to potentially bid for equipment having perceived value.
iv) As a practical matter, the law frowns harshly upon self-help evictions and landlords must therefore be proactive in notifying tenants of the intent to fully exercise all lien rights so as to guard against disappearing collateral.

4) Some other concerns:
a) Is there a potential replacement tenant? If so, care should be taken in drafting a lease assignment that maintains the liability of the original lessee and guarantor.
b) Is the tenant offering a bill of sale for equipment in exchange for a reduction of the tenant or guarantor's obligation for future rent? If so, care must be taken to ensure that any lien issues are adequately addressed.
c) *Self-Help Eviction?* Many times, the landlord will get no cooperation in negotiating possession prior to filing a lawsuit. Resist the urge to engage in a self-help eviction by changing the locks prior to receiving a court order for possession. While most leases give landlords the right to do this, self-help evictions are one of the rare instances in

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which the lease does not control. Well-established Indiana law provides that landlords can be liable for damage to property of for lost business opportunity if the locks are changed absent the tenant's permission. Moreover, law enforcement officers may act to stop an unauthorized changing of the locks, even if presented with a lease that specifically allows it.

How Does Litigation Fit In?

Just because litigation is mentioned last in this list does not necessarily mean that it is the last resort. To the contrary, it often makes sense for litigation to be initiated early in the process on a parallel track with efforts to negotiate all of the things previously discussed herein. The main reason for this is Indiana's statutory mechanism for obtaining a *preliminary determination of possession*. The motion for preliminary possession must be accompanied by a civil complaint similar to a complaint initiating any other lawsuit.

1) *Preliminary Determination of Possession* – Because lawsuits can take months or even years to conclude, Indiana's legislature has created a statutory remedy that gives the landlord immediate possession provided the evidence shows the landlord will more likely than not ultimately prevail at trial.
   a) A hearing is typically awarded within 10 days to two weeks of filing.
   b) The landlord may mitigate damages by re-leasing in the interim of the lawsuit.
   c) Seeking an order of preliminary possession provides good back-up plan in case negotiations fall through, and also provides good leverage.
   d) A possession hearing can also bring things to a head with a non-communicative tenant.
   e) Once preliminary possession is obtained, the landlord may attempt to expedite ultimate resolution of the case by pursuing summary judgment for remedies available under the lease.

2) Primary Items to Seek in the Lawsuit
   a) Unpaid Rent. Also consider whether the lease contains an acceleration clause.
   b) Hopefully, the lease requires that attorney fees be paid to the prevailing party.
   c) Is there a personal guaranty? Because the tenant entity is likely insolvent, this is probably the best chance of recouping any lost rent. If there is no personal guaranty, the landlord and attorney should explore whether any unlawful, deceitful or fraudulent acts might allow a piercing of the corporate veil.

3) Remember Cardinal Rule No. 1 – Keep your objective in mind, and communicate with your attorney. If you've accomplished your goal of obtaining possession and don't believe the tenant or personal guarantor is solvent, be careful of throwing good money after bad by pursuing an uncollectible judgment. On the other hand, the judgment will, at least, create a lien against the judgment debtor's real property.

4) Landlord/Attorney Relationship – Hopefully, the landlord and attorney have a pre-existing relationship that allows for the quickest possible filing of the lawsuit and preliminary

determination of possession, which in turn allows for the quickest possible preliminary possession hearing. We advise our landlord and property manager clients to be prepared to provide us with a care package of information consisting of: (1) the lease and all amendments thereto; (2) payment ledger; (3) default correspondence and, if applicable; (4) guaranty; and (5) assignment documentation, which usually allows us to file that same day. When possible, we also personally file the complaint with the Court, which allows us to speak directly to the Court staff in order to get the quickest available possession hearing.

5) Tenant Defenses – Throughout the negotiation process, and prior to and during litigation, the landlord and attorney must consider what potential defenses the tenant may have to non-payment of rent. Here are a few of the most common:
   a) Waiver/estoppel – Has the landlord done or said anything to forgive late payment or to waive rights for a specific breach?
   b) Constructive eviction – Has the landlord done (or failed to do) anything that forces the tenant to vacate?
   c) Surrender of the premises and acceptance by the Landlord – Unless the lease provides for continuing rental obligations post-surrender, a bilateral surrender agreement can terminate the tenant's obligation to pay rent. If the lease does not provide for continuing rent, certain actions by the landlord can constitute surrender by operation of law, thus ending the tenant's rental obligations.
   d) Setoff of damages – The tenant might argue a breach by the landlord sets off damages owed by the tenant. For example – square footage was not as represented, parking was not as promised, promised tenant improvement funds were not paid, or common area maintenance was not performed as promised.
   e) Accord and Satisfaction – Has the landlord accepted any payment by the tenant accompanied by the words "paid in full" or something similar?

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