

Surety bonds: An alternative security for leases

As businesses adapt to the ever-changing market, tenants increasingly are attempting to reduce their costs when it comes to real estate. One way that tenants can do this is through the use of surety bonds as the security for leases.

Surety bonds provide for a third-party contractual guaranty, requiring the surety to pay if the principal to a contract defaults. Surety bonds have long been used in the construction context due to their simplicity and the general success with enforcement of the surety bonds. Recently, tenants have started to request to use surety bonds instead of a security deposit, letter of credit or personal guaranty due to the fact that surety bonds can be cheaper and they do not require the tenant to tie up the same amount of capital as a letter of credit or security deposit.

While surety bonds provide for a cheaper means to obtain security for the lease, when there is a default, they may be more difficult to enforce than a security deposit or a letter of credit.

• **Enforcement issues.** While letters of credit often are used as lease credit enhancements, there is not the same history with sureties and, thus, the evidence on their enforceability is limited. Sureties generally do not have the same relationship with the tenant as a bank providing a letter of credit does and thus tend to be less willing to pay a draw request. Banks tend to pay draw



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requests, as long as the letter of credit is properly drafted. On the other hand, sureties are more likely to dispute a draw request. Insurance providers are incentivized not to pay a draw request to increase profitability. It likely will be easier for

a landlord to collect on a monetary default rather than a nonmonetary default, due to the decreased likelihood that a surety will have the grounds to dispute a monetary default. If litigation occurs, courts generally enforce the surety bond as written, since a surety bond is an independent contractual obligation, similar to any other contract. As a result, while collection on a surety may be delayed beyond what a landlord could expect from a letter of credit payment or performance guaranty, landlords ultimately should be able to realize the proceeds of a surety bond.

• **Bankruptcy proceedings.** One benefit of a surety bond with regard to tenant bankruptcy is that an automatic stay should not apply to a draw on a surety bond or letter of credit. This is contrasted with a cash deposit where permission from the bankruptcy court would be required to apply the deposit to unpaid rent. However, even with a surety bond, it is possible that a



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required act prior to the draw will be subject to the automatic stay. An example of this is if a surety bond is only payable after a lease is terminated or a notice of default is delivered, then the termination or notice of default may be subject to an automatic stay. If the landlord is unable to obtain relief from the stay, then the landlord's ability to draw on the surety bond will be delayed. Thus, landlords should include language that, in the case of tenant bankruptcy, no notice shall be required before landlords may draw on the surety bond.

When a landlord does draw on the surety bond, if the money is held as a cash security, it could be treated like a deposit and be subject to an automatic stay. To avoid this, landlords should make partial draw requests and apply the money to outstanding rents or return any unused funds to the surety.

A surety bond must be drawn upon if it is about to expire and is not renewed; otherwise, a landlord cannot benefit from the surety bond. Based on the foregoing, if a tenant does not replace the surety at the expiration, a landlord should have the option to use the drawn proceeds to unilaterally fund a replacement surety bond so that

the landlord does not have to hold the money as a cash security.

• **Risks of surety bonds and ways landlords can protect against them.** Landlords should always require that the surety has a top credit rating, under AM Best or other reliable rating agency, in order to ensure that they will have the ability to pay any draw request.

Surety bonds should allow for a landlord to draw on a surety bond without any action by a tenant in order to reduce the ability of the surety to claim that it does not have to pay the draw request, which in turn will reduce the risk of litigation and the automatic stay dilemma set forth above. Ideally, the surety should waive any of its defenses and those of a tenant, which is a customary request in the context of guaranties. However, sureties are likely to push back on such a request, as they are less familiar with lease guaranty concepts and more familiar with construction bonds, where such waivers are not necessarily commonplace.

• **Conclusion.** Ultimately, surety bonds, as security for leases, appear to have a higher risk of nonenforceability than a letter of credit; however, with the appropriate measures, it is likely a landlord will be able to collect on the surety bond. For all of the above reasons, there is a chance that collection under a surety bond may be delayed, but, in the end, such collection is unlikely to be prevented.▲

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