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Probate & Property

November/December 2002

Vol. 16 No. 6

Letters of Credit in Lease Transactions, Part II: Drafting Tips

By Susan Fowler McNally, Carter Klein, and Michael Abrams

Susan Fowler McNally is a partner in Gilchrist & Rutter in Santa Monica, California; Carter Klein is a partner in Jenner & Block, LLC, in Chicago, Illinois; and Michael Abrams is a partner in Gilchrist & Rutter in Santa Monica, California.

If the landlord allows or requires its tenant to post a letter of credit (L/C), instead of a cash security deposit or prepaid rent, to secure the tenant's lease obligations, the landlord must consider what form, language, and draw conditions should be contained in the L/C. Using an L/C with the proper format, language, and draw conditions will minimize or avoid problems. The L/C should provide the landlord with a prompt, unrestricted, liquid, and indefeasible source of payment for damages due from the tenant under the terms of the lease even in the face of a tenant bankruptcy. Set forth below are some drafting tips and other points to avoid problems and pitfalls with L/Cs securing tenant obligations.

Use the ISP Instead of the UCP
A standby L/C should be used to secure lease obligations, rather than a documentary or commercial L/C designed to pay for goods purchased in international trade. A standby L/C is meant to be drawn upon only if a default occurs. Besides UCC Art. 5, banks use two principal regimes or conventions to govern their standby letters of credit: the Uniform Customs and Practice for Documentary Credits (UCP) promulgated by the International Chamber of Commerce effective January 1, 1994 (found in ICC Publication No. 500), and the International Standby Practices 1998 (ISP) promulgated jointly by the Institute for International Banking Law and Practice and the International Chamber of Commerce, effective January 1, 1999 (found in ICC Publication No. 590).

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Probate & Property November/December 2002 Vol. 16 No. 6
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1299 Ocean Avenue, Suite 900 • Santa Monica, CA 90404
310-393-4000 • fax: 310-394-4700 • www.grlawyers.com

From the landlord's perspective as beneficiary, the preferred governing regime for an L/C taken in lieu of a security deposit should be the ISP. It is specifically designed for standby letters of credit, has clearer rules on questions involving standby L/Cs, including assignment of proceeds and transfers of the L/C itself, and avoids several traps for the unwary found in the UCP. Those traps include: (1) if the issuer is not open for business because of a force majeure event, the beneficiary cannot effect a draw if the issuer does not reopen before the L/C expires; (2) if installment draws are contemplated and one or more installment draws are not made, the beneficiary cannot make subsequent draws; (3) if transport documents are to be presented, they must not be presented more than 21 days after their date; and (4) documents cannot be inconsistent

(3) does not require the wording of the draw documents specified in the L/C to be verbatim or exact language.

Do Not Require Persons Identified by Name to Sign Draw Documents

In one case, an individual landlord had died and his personally signed certificate was required to effect a draw on an L/C securing a tenant's lease obligations. The certificate, of course, could not be supplied. The court upheld the issuer's right to dishonor. *Samuel Rappaport Family Partnership v. Meridian Bank*, 657 A.2d 17, 22 (Pa. Super. Ct. 1995). But the requirement for a document to be presented by a specific named individual should be distinguished from the right of a successor entity to draw on an L/C. Both the UCC and the ISP permit transfers by operation of law so that a

all-or-nothing draw may not suit the situation in which a breach has occurred. The landlord may not want to terminate the lease but only draw for the amount of the breach.

Do Not Specify Deployment of Funds Drawn

The landlord should not be required to specify the use or deployment of the funds drawn other than in a very general nature, such as pursuant to the terms of or on account of a default under the lease. The landlord wants the freedom to disburse the funds without restrictions. If the landlord is required to place the funds into an escrow, it may require a court order or concessions to the tenant to get them out.

Set the Expiration Date Beyond the Lease Termination Date

Optimally, the L/C should have an outside or final expiration date beyond the expiration of the lease to allow the landlord to calculate and recover damages to the premises and holdover rent and to protect against a bankruptcy of the tenant within 90 days beyond receipt of the last payment under the lease. Use a clawback provision in the lease (as explained below), or, in the alternative, draw on the L/C for the final payments due under the lease. If the final payments due are paid from draws on the L/C, the landlord need not worry about a preference because the draw proceeds represent funds of the issuing bank and not the debtor. Cf. *In re Powerine Oil Co. v. Koch Oil Co.*, 59 F.3d 969, 972 (9th Cir. 1995) (preference found because creditor accepted late payment instead of drawing on letter of credit).

A clawback provision in the lease or the L/C permits the L/C to be drawn upon in an amount equal to that paid by the tenant to the landlord in the preference period if the tenant files for bankruptcy within the preference period (usually 90 days from the last payment paid to the landlord). The amount so drawn is held by the landlord or in escrow to secure against any preference claims that may be asserted against the landlord on account of payments made to the landlord by the tenant within the preference period. If no preference claims are

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with one another. Under the ISP, each of these troublesome pitfalls is eliminated. For example, if the issuer is closed when the L/C expires because of a force majeure event, the beneficiary under an ISP-governed L/C has an additional 30 days to make a presentment from the day the issuer reopens. By incorporating the ISP into an L/C, there is no need to worry about drafting additional terms in the L/C to avoid the pitfalls contained in the UCP. Most banks will issue standbys governed by the ISP upon request.

Keep the Draw Conditions Simple

A landlord is better able to make an error-free draw if the L/C it receives from the tenant's bank (1) calls for few documents, (2) minimizes the verbiage in the documents to be presented, and

bankruptcy trustee, receiver, decedent's estate, or a successor by merger or name change is permitted to make a draw on an L/C of its predecessor even though the L/C is not transferable. The rule does not extend to asset sales or other consensual or contractual transfers of the L/C unless the L/C is expressly made transferable and the terms of transfer are followed.

Do Not Require Third Persons to Sign Draw Documents

Avoid as a draw condition the presentment of any certificate or document that must be signed by the tenant, a court, an arbitrator, or any third party over which the landlord has no control.

Allow Partial Draws

The landlord should be able to make multiple partial draws on the L/C. An

brought or if they are waived or released, the money from the letter of credit draw is given back to the applicant. If a preference claim is brought, the money will be accessed by the landlord to reimburse it for the amount of the preference claim that is repaid to the debtor's estate.

Shorten the Time Period to Honor

Under the UCC, the UCP, and the ISP, an issuer of an L/C has a reasonable time (up to seven business days after documents are presented) to honor or give notice of dishonor. If the L/C specifies no time period that the issuer has to examine and honor, the default rule is that the issuer has a reasonable time, up to seven business days, to honor. A landlord should consider shortening the outside time limit for the issuer to honor to three business days or less. Given the simplicity of the documentation to effect a landlord's draw, three business days should be more than ample time for an issuer to honor the draw. Besides getting the landlord its money sooner, the shorter time period will give the tenant less time to contest the draw. If the L/C is about to expire, the shorter time period to honor will also give the landlord more time to correct and re-present technically defective draw presentments.

Avoid Presentment Letters of Credit

Presentment letters of credit require the original of the L/C, including all amendments, to be presented along with other documents specified by the terms of the L/C to effect a draw. This requirement has several benefits for the issuer. For example, it provides the issuer with some assurance that it is dealing with the true beneficiary. In addition, for multiple draws, the issuer can make a notation of the amount drawn on the L/C itself to help the issuer guard against overdrafts. For these reasons, most issuers will insist on use of presentment L/Cs, although they make exceptions for good customers and certain types of L/Cs such as those backing municipal bonds or obligations by brokers owed to clearing corporations. If pressed, the issuer may consent to issue a nonpresentment L/C. From the beneficiary's standpoint, having to present the original of the L/C as

a requirement for a draw can create serious problems. If the original of the L/C is lost or destroyed, the landlord may be unable to effect a draw. One story has it that a municipality locked a presentment L/C in its safe and lost the combination. When the safe was blown open, the original L/C was destroyed and the municipality had to beg the issuer for issuance of a duplicate original so it could effect a draw. Cases consistently have held that copies are not permitted as substitutes for the lost original and the issuer is under no obligation to issue a duplicate original. See, e.g., *Brul v. MidAmerican Bank & Trust Co.*, 820 F. Supp. 1311, 1313-15 (D. Kan. 1993) (upholding issuer's dishonor of draw under presentment letter of credit when only a copy of letter of credit was presented, even though it was accompanied by an indemnity and an affidavit that the original was lost and had not been assigned or transferred). Neither the UCC nor the UCP has a rule dealing with lost originals, unlike Article 3's rules on lost negotiable instruments. Although the ISP has such a rule, the issuer is not required to replace the original but may do so in its discretion and on terms protective of it.

Landlords sometimes have hundreds of tenants, each one of which may have a letter of credit posted in lieu of a security deposit to secure the tenant's lease obligations. Keeping track of each of the original L/Cs and all amendments constitutes an administrative burden. By requiring use of a uniform form of nonpresentment L/C, the landlord can automate its presentment process if a tenant defaults by having the form of draft and draw certificate computerized. It can be ready for signature and presentment within minutes by filling in the blanks, such as date, the amount of the draw, the issuer, the letter of credit number, and the tenant.

There is one advantage to the beneficiary of having a presentment L/C. Under UCC § 5-114(d), a beneficiary can require the issuer to acknowledge an assignment of proceeds of a presentment credit, but the issuer can insist on reasonable conditions of assignment, including exhibiting the original and paying a fee. If the L/C is not a presentment L/C, then the beneficiary has no

right to insist on the issuer's consent to an assignment of proceeds. Most issuers, however, will consent to an assignment of proceeds anyway if requested by the beneficiary. The assignment will be on the issuer's forms and terms, one of which will be payment of a fee. If assignment of proceeds of the landlord's L/C securing lease obligations is important to the landlord because its lender insists on an assignment of proceeds, then a nonpresentment L/C itself could still be drafted to provide that it is transferable and the draw proceeds assignable. If this is done, then from the beneficiary's perspective, there is no good reason to require presentation of the original L/C and all amendments as a condition of the draw.

Allow Fax Presentments

Unless the L/C otherwise specifies, originals of each document called for by the L/C must be presented; copies or facsimile signed documents will not comply. To facilitate draws, the L/C should specifically permit draw documents to be presented by telecopy or other electronic means. The L/C should specify the issuing bank's telecopier number to be used for presentment of draw documents by fax. Fax presentments will make presentment quicker and easier, avoid losses and delays in transit, and avoid problems when originals required to be presented are lost or destroyed. Obviously, fax presentment requires the L/C not to be a presentment L/C, so all the considerations mentioned in the preceding paragraphs apply to fax presentments as well.

Use a Transferable Letter of Credit

An L/C is not transferable unless it expressly so states. If the landlord sells the property, the purchaser will want all L/Cs held in lieu of security deposits as well as any cash security deposits transferred to it. The landlord's lender may also insist on a transfer of the L/C into the name of the lender. Accordingly, each L/C taken by a landlord in lieu of a security deposit should be designated as transferable. To facilitate transfer, the L/C should refer to and contain as exhibits the form of transfer notice and acknowledgment and, if possible, specify the transfer fee.

Use an Automatic Renewal and Expiration Draft Provision

Most letters of credit are issued for a term of one year or less. Banks have regulatory, prudent lending, and capital adequacy concerns about issuing longer term letters of credit. Commercial office building leases with or without tenant build-out costs tend to be long term. To bridge the gap between the need of the issuer to keep the expiration date of its L/C limited to a one-year period and the landlord's need to keep the L/C in place for the duration of the lease, an automatic renewal provision should be included in the L/C. This provision will state that the L/C is deemed to be automatically renewed for additional one year periods unless the issuer notifies the landlord-beneficiary a certain number of days before the expiration date (say 60 days) that the L/C will not be renewed. Until timely notice of nonrenewal is given by the issuer, the L/C will automatically

should also provide that the landlord can draw on it by submitting a document stating that the issuer failed to renew the credit. For automatic stay considerations, the renewal or draw provision should be drafted as an independent ground for the draw, apart from any default under the lease. If the lease makes the failure to renew the L/C a set number of days before expiration a default under the lease, then the landlord must decide whether it wants to terminate the lease and exercise its remedies or simply hold the draw proceeds as it would a cash security deposit and continue with the lease.

The agreement dealing with what to do with early expiration draw proceeds will usually be stated in the lease or in the certificate to be presented to the issuer to effect a draw for failure to renew, or both. Typically, some kind of escrow or security deposit arrangement will be negotiated and provided for in

Usually, failure to renew or extend an L/C is because of the issuer's dissatisfaction with the tenant-applicant's financial condition, triggering the issuer's desire to liquidate the tenant's liabilities before the tenant's financial condition deteriorates further. The lease should be drafted so that failure to maintain the L/C is an event of default and not just an event that entitles the landlord to transform the L/C security for the lease into a cash security deposit. If the tenant is unable to maintain an L/C, then the landlord should consider declaring the lease in default and immediately applying the draw proceeds to cover its damages. Doing so should avoid the problem of "transformation" of the draw proceeds into a security deposit. If such a draw occurs before bankruptcy, it would have the advantages of avoiding problems arising from the automatic stay, the *ipso facto* clause of the Bankruptcy Code, and the rent damages cap of Bankruptcy Code § 502(b)(6), all of which can apply to block a landlord's right to apply a security deposit to lease damages. This action, however, is extreme and may not be acceptable to most tenants, and even may not be in the landlord's economic interest.

Landlords sometimes have hundreds of tenants, each one of which may have a letter of credit posted in lieu of a security deposit to secure the tenant's lease obligations.

extend for one-year periods until an ultimate outside expiration date, if one is stated, or a cancellation and surrender of the credit is agreed to by the beneficiary.

As noted above, if an ultimate expiration date is stated in the L/C, it should be at least 90 days and preferably 105 days or more beyond the termination of the lease to give the landlord time to determine whether there was any damage to the leasehold, whether holdover rent was due, and whether there were bankruptcy proceedings involving the tenant within the applicable preference period. If an outside expiration date is stated in the L/C, the landlord should remember to require this date to be extended by amendment to the L/C as a condition of any renewal or extension of the lease beyond that date.

If notice of nonrenewal is given before the lease terminates, the L/C

the lease. The parties can agree on escrowing proceeds from a draw on the L/C for failure to renew or they can agree that the landlord will hold them in a segregated account under its sole control, but subject to the contractual obligation to apply them to the lease obligations in the event of a default. The agreement or certificate will normally state where the proceeds from the draw for failure to renew will be deposited and what arrangements will govern the landlord's subsequent use of them. Because there is no current default other than failure to renew the L/C, there are no unpaid monetary defaults under the lease to which the draw proceeds can be applied unless the landlord terminates the lease based on the tenant's failure to renew the letter of credit—a sometimes difficult decision to make if the tenant is otherwise current in its lease payments.

Check the Credit of the Issuing Bank

The landlord should check the creditworthiness and acceptability of the issuing bank. Some banks do become insolvent. Bank rating services, such as Fitch Ratings (www.fitchratings.com), are available to determine the strength and acceptability of the issuer. Also consider making deterioration in the rating of the issuing bank group's debt or deposits a default under the lease unless the letter of credit is replaced within a set number of days after notice with one issued by a creditworthy bank.

Obtain U.S. Bank Advice or Confirmation of Foreign Bank L/Cs

Although some foreign banks are as strong as or stronger than U.S. banks, convenience of presentment as well as enforceability and jurisdiction concerns in the event of a dispute dictate that a

U.S. bank or at least a U.S. branch of a foreign bank be used. If a foreign bank is used and its credit strength is questionable, a confirmation of the foreign bank's L/C should be obtained from a reputable U.S. bank. All foreign bank letters of credit should at least be advised through a U.S. bank, so the landlord as beneficiary can use the advising bank to check on the authenticity of the L/C when issued, to assist in checking on its status from time to time after its issuance, and for assistance in effecting draws.

If presentment of documents may be made by telecopier, the location of the issuing bank is less important as a matter of convenience and logistics, although it can still be important if suit must be threatened or brought against the issuing bank for wrongful dishonor. Obviously, the landlord would prefer to litigate in its own jurisdiction rather than in a distant city, state, or country. If paper documents must be physically presented rather than telecopied, time and convenience favor use of an issuing bank located in the vicinity of the landlord. This is not of major importance, however, because documents can be sent almost anywhere in the United States in one business day by courier. If documents are dishonored, the issuer must give notice of dishonor by telecommunication.

Draft the Draw Trigger
Conditions and Lease to
Avoid Having to Give Notice
of Default or Intent to Draw
If the Tenant Is in
Bankruptcy

Having an L/C as security for a debt does not ensure that notices to or actions taken against the tenant to effect a draw on the L/C, such as ter-

minating the lease, will not violate the automatic stay applicable in the event of the tenant's bankruptcy. Standby letters of credit, either alone or in conjunction with the underlying lease agreement, may require that declaration of a default be communicated to the tenant as a condition of the draw and a certification of the default so declared be submitted to the issuer. Other variants on the draw conditions, stated either in the lease or the letter of credit itself, may include a requirement that the landlord furnish the tenant with a notice of the landlord's intent to make a draw a set number of days before the draw, that the landlord certify the tenant has not cured the defaults before expiration of any applicable cure periods, that the landlord certify it has sent to the tenant copies of its notices of default at least a set number of days before the draw, and that the landlord furnish proof of mailing or delivery of such notices to the tenant or the issuer.

Under Bankruptcy Code § 362 it may make a difference how the draw conditions are worded on whether a draw will violate the automatic stay. The cases are split on whether merely giving notice of a lease default to the tenant after bankruptcy as a condition to effect a draw on a letter of credit constitutes a violation of the automatic stay. Most courts have held, and the better view is, that the notice of default should be characterized as informational; because no actual action is taken to obtain from or deprive the debtor of property, the stay is not violated. See, e.g., *In re Prime Motor Inns, Inc.* 130 B.R. 610 (S.D. Fla. 1991). If a notice is required to be given to the tenant that the lease is or will be terminated, it could be held that the landlord has violated the

automatic stay. Accordingly, the draw conditions on the L/C should not be drafted in such a way that, as a precondition of the draw, either under the terms of the L/C or the terms of the lease, the landlord must give a notice or make a demand or take an action, such as termination of the lease, that could be construed as a violation of the automatic stay.

Conclusion

Although L/Cs are a more cumbersome form of security for a lease than a cash deposit or prepayment of rent, difficulties arising from using L/Cs can be minimized by following the guidelines in this article on format, language, and draw conditions. Furthermore, in the event of a tenant bankruptcy, the L/C may even prove to be better than cash! ■



1299 Ocean Avenue, Suite 900
Santa Monica, CA 90404
310-393-4000 • fax: 310-394-4700
www.grlawyers.com



E-mail: smcnally@grlawyers.com



E-mail: mabrams@grlawyers.com

Gilchrist & Rutter
1299 Ocean Avenue, Suite 900
Santa Monica, CA 90404
310-393-4000 • fax: 310-394-4700
www.grlawyers.com

ABOUT THE AUTHORS

Susan Fowler McNally is a partner at Gilchrist & Rutter Professional Corporation, Santa Monica, California, where her practice focuses on real estate transactions, including purchases and sales; commercial and retail leasing; secured and unsecured financings; telecommunications licenses and service agreements; and construction, design professional and consultant contracts. Ms. McNally is a frequent author and speaker for bar association publications, meetings, national conferences and seminar.

(E-mail: smcnally@grlawyers.com)

Carter H. Klein is a partner with Jenner & Block, LLC, Chicago, where his law practice focuses on banking, commercial lending, loan workouts, consumer credit, uniform commercial code, sales, franchising and distribution, and international business transactions. Mr. Klein is a member of the Chicago, Illinois State, and American Bar Associations, and is a frequent author in industry publications.

(E-mail: cklein@jenner.com)

Michael S. Abrams is a partner at Gilchrist & Rutter Professional Corporation, Santa Monica, California, where his practice focuses on the representation of creditors and debtors in bankruptcy, reorganization, workouts and other insolvency proceedings. Mr. Abrams has substantial experience representing landlords and debtors in complex real estate workouts and bankruptcies.

(E-mail: mabrams@grlawyers.com)

This article was originally printed in Probate & Property November/December 2002 Vol. 16 No. 6.

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