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Letters of Credit in Lease Transactions, Part I: Advantages to Landlord and Landlord's Lender

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Landlords generally prefer to enter into leases with creditworthy tenants—tenants with high and demonstrable net worth, substantial tangible and liquid assets, and a long track record of successful operation and paying bills. Most landlords do not have that luxury. Moreover, even tenants that start out cash flush or rock solid can suffer credit deterioration to the point that they become high-risk tenants long before the normal commercial lease expires. Recent examples include Ha-Lo Industries, e-Toys, and Enron.

To induce landlords to accept the risks associated with renting to non- or marginally creditworthy tenants, various credit enhancements or security devices are offered— cash security deposits, prepaid rent, guaranties, security agreements, lease bonds, and letters of credit. A letter of credit is one of the most widely accepted forms of security for commercial leases. The discussion below will concentrate on the proper use and advantages of letters of credit to secure the tenant's obligations to the landlord in the event of a bankruptcy of the tenant.

Bankruptcy issues Affecting Leases

The rules governing the treatment of nonresidential real property leases in bankruptcy are, on their face, relatively simple, but in practice can be quite complex. They subject the landlord to the vagaries of the Bankruptcy Code and the competing interests of the debtor and its other creditors. The landlord's claims in bankruptcy are treated differently based on whether the debtor assumes or rejects the lease. If the bankrupt debtor-tenant assumes the lease, it is reinstated and the landlord must be paid all arrearages and all nonmonetary defaults must be cured. If the tenant that has assumed its lease subsequently breaches it, the landlord has a claim for breach either as an administrative expense entitled to priority if the tenant-debtor is still in bankruptcy or, if the tenant-debtor has emerged as a reorganized entity, under applicable state law. Upon assumption of the lease (unless the case is subsequently converted to a liquidation) the landlord's rights are once again governed by the

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terms of the lease and applicable state law. Accordingly, the security deposit device the landlord holds, whether it be prepaid rent, cash, a letter of credit, or otherwise, is available to compensate the landlord to the full extent permitted by applicable state law; the bankruptcy limitations no longer apply.

If the bankrupt tenant does not immediately assume its lease following bankruptcy, several provisions of the Bankruptcy Code may come into play to hamstring the landlord's claims for and ability to be fully compensated for breach because of the tenant's insolvency, breach of the lease, or rejection of the lease:

- the automatic stay of Bankruptcy Code § 362 prohibits the landlord from terminating the lease without first obtaining relief from the automatic stay;
- the automatic stay of Section 362 prohibits the landlord from realizing on any of the tenant's property, including cash security deposits that may be posted to secure lease obligations, without obtaining relief from the automatic stay after a proper showing;
- the *ipso facto* clause of Bankruptcy Code § 365(e) prevents the landlord from terminating the lease solely because of the tenant's bankruptcy or deteriorated financial condition;
- even if the lease has been breached, under Section 365 the landlord may not terminate the lease and must allow the tenant to cure any breach-

es under the lease within the 60-day or longer period allowed by the bankruptcy court;

- any late paid rents or other amounts due under the lease that are paid within 90 days of the tenant's bankruptcy may be subject to recovery from the landlord as a preference under Bankruptcy Code § 547, if the applicable requirements for a preference are met;
- even if the tenant rejects the lease, the landlord's damages are subject to a statutory cap under Bankruptcy Code § 502(b)(6) of the higher of (1) one year's rent or (2) the lower of 15% of the lease rentals for the remaining term, not to exceed three years, and, if the amount of the cash security deposit or prepaid rent exceeds the cap for post-petition damages, then the landlord must return the excess to the tenant's bankruptcy estate; and
- if the lease is assumed by the tenant, under Section 365, the lease can be assigned over the landlord's objection so long as the assignee has a financial condition comparable to what the tenant's financial condition was at the time the lease was initially entered into. In fact, if the debtor-tenant is able to assign the lease at a higher rent than the original lease, Section 365 even allows the debtor-tenant to retain this transfer premium.

It is not uncommon for landlords to require guaranties from the principals or parent corporations of higher risk tenants.

Security Deposits and Prepaid Rent

Historically, the typical forms of security obtained by landlords were either cash security deposits or prepaid rent. Both have certain limitations under bankruptcy and state laws. In bankruptcy, the cash security deposit is considered an asset of the debtor's bankruptcy estate. The landlord is required to obtain relief from the automatic stay in order to offset the security deposit against the landlord's damages. If the bankruptcy court views the security deposit as excessive, it may even allow the debtor-tenant to use a portion of it during the pendency of the bankruptcy proceedings to help it reorganize. To the extent that the cash security deposit exceeds the allowed claim of the landlord under Section 502(b)(6), the excess is payable to the bankruptcy estate.

Applicable state law may also place limitations on the use of security deposits. In some states, a landlord may apply the security deposit only to the payment of rent, the costs to repair damage to the premises caused by the tenant, and the costs to clean the premises upon termination. State law may also require a landlord to return any unapplied portion of the security deposit to the tenant within a short period of time, such as 30 days. See, e.g., CAL. CIV. CODE § 1950.7(c). As a result, the security deposit may not be available to offset all of the landlord's actual damages.

Prepaid rent generally is treated like a security deposit under both state and bankruptcy law. *Zaconick v. McKee*, 310 F.2d 12 (5th Cir. 1962). Further, at least one bankruptcy court has held that the

prepaid amount of future rent may not be offset against the landlord's damages and such amount must be turned over to the bankruptcy estate. *In re Orangebrook Concessions*, 47 B.R. 858 (S. D. Fla. 1985).

Guaranty

It is not uncommon for landlords to require guaranties from the principals or parent corporations of higher risk tenants. However, in many instances, the guaranty is either not available or is of limited value if the tenant fails. Although Section 362(a) provides for an automatic stay that prevents the debtor's creditors from taking possession of, or enforcing a lien against, the debtor's property and further prohibits such creditors from initiating or continuing any litigation against the debtor, the automatic stay does not prevent a landlord from pursuing an independent claim against a bankrupt debtor's guarantor. In addition, the few courts that have decided the issue have held that the statutory damage caps under Section 502(b)(6) do not limit a landlord's claim against a nondebtor guarantor unless the guarantor is itself in bankruptcy. See, e.g., *In re Modern Textile*, 900 F.2d 1184, 1191 (8th Cir. 1990).

The rationale of not applying the Section 502(b)(6) cap to claims against a guarantor is that the guarantor's assets are not property of the bankrupt tenant's estate. Courts that take this position, however, do not address the guarantor's subrogation rights and indemnity claims, which may cause the tenant's estate to be depleted by the amount of the landlord's entire claim paid by the guarantor, including the portion that exceeds the

Section 502(b)(6) cap. See *Levit v. Ingersoll Rand Financial Corp. (In re Deprizio Constr. Co.)*, 874 F.2d 1186 (7th Cir. 1989).

Advantages of Letter of Credit

For a relatively small fee and assuming sufficient collateral or creditworthiness of the tenant or a guarantor, a tenant may be able to apply for and have its bank issue to its landlord a letter of credit (L/C) to secure the tenant's obligations under a longterm lease. If the L/C is large enough, the landlord may enter into a lease with a tenant, such as a start-up hi-tech company, that the landlord would otherwise refuse because of the tenant's lack of creditworthiness. From the tenant's perspective, an L/C may be preferable to a large security deposit. An L/C will not necessarily tie up large amounts of the tenant's cash or other liquid collateral, as would a security deposit. In some cases, nonliquid assets such as equipment can secure the tenant's L/C reimbursement obligation. Cash that would otherwise be pledged as a security deposit can be deployed as working capital in the tenant's business.

Avoids Underlying Disputes

An L/C is an independent obligation of the issuing bank. As long as conforming documents specified by the terms of the L/C are presented to the issuer before the expiration date and no fraud is involved, the issuer must honor the draw on the letter of credit. The credit of the issuer stands behind the obligation of the tenant. If the tenant is insolvent and/or bankrupt, the issuer still must honor the beneficiary's conforming draws on the L/C. Even if the tenant or a guarantor disputes the claim of the landlord that the tenant has defaulted in its lease obligations or the tenant disputes the amount of damages the landlord claims, the landlord can still draw on the L/C notwithstanding those defenses and claims. The parties must argue about or litigate the tenant's claims outside of the draw and without involvement of the L/C issuing bank.

Cannot Enjoin an L/C Draw Except for Fraud

Section 5-109 of Revised Article 5 of the Uniform Commercial Code (UCC) provides that a draw under an L/C cannot be enjoined unless the applicant can show fraud and all other conditions for equitable relief are met. The comments and case law have interpreted the fraud requirement to require a showing of egregious material fraud that vitiates the entire transaction. See Official Comment 1 to Revised § 5-109 and cases cited therein. The additional conditions that must be met to enjoin a draw against an L/C include showing probable success in proving fraud, irreparable harm, no adequate remedy at law, balance of the equities, and the serving of the public interest. In appropriate cases, a bond must be posted by the applicant to preserve the rights the landlord will lose if the L/C draw is enjoined and the credit expires. Appellate case law follows the statute—it is very difficult to successfully enjoin a facially conforming draw on an L/C. *Intraworld Industries, Inc. v. Girard Trust Bank*, 336 A.2d 316 (Pa. 1975). As further discouragement to injunction suits against draws on L/Cs that are really contract disputes, in most states Section 5-111(e) of Revised Article 5 of the UCC requires the unsuccessful party in an action to enjoin a draw on an L/C to pay the prevailing party's attorney fees. John Dolan, *Making the Case for Mandatory Attorney's Fees*, Letters of Credit Web Rep. (A.S. Pratt & Sons), available at www.lettersofcreditonline.com (last visited March 6, 2002). Only New York and New Jersey omit the award of attorney fees in such cases or make the award discretionary.

Avoids Automatic Stay

From the bankruptcy perspective, an L/C has several distinct advantages over a cash security deposit. Because the funds drawn on an L/C are regarded as belonging to the issuing bank and not the tenant-applicant or a tenant for whose benefit the L/C is posted, the proceeds of an L/C draw are not considered property of the tenant's estate under bankruptcy law. Accordingly, they can be applied to damages due the landlord for

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breach of the lease without seeking relief from the automatic stay.

Avoids Section 502(b)(6) Cap

A bankruptcy court should not require the landlord to return L/C draw proceeds of its bankrupt debtor that exceed the cap calculated in accordance with Section 502(b)(6) because L/Cs are independent obligations of the issuing bank; the cap applies only to obligations of the bankrupt debtor. See Geoffrey L. Berman, Peter M. Gilhuly & Shira Roth, *Landlords Use Letters of Credit to Bypass the Claim Cap of 502(b)(6)*, 2001 AM. BANKR. INST. J. LEXIS 222 (Dec. 2001). As noted above, the cases that have decided the issue hold that even guaranties of leases are not subject to the cap of Section 502(b)(6).

Avoids *Ipsa Facto* Clause

Can a landlord declare a default under a lease and then draw on the tenant's L/C solely because of the tenant's bankruptcy filing? Bankruptcy Code § 365(e) prohibits a creditor or obligee under an executory contract (like a commercial lease) from asserting a default solely because of the debtor's financial condition or its filing for bankruptcy protection. If the tenant is adhering to its obligations under the lease, including the payment of rents and other amounts due, then the need to declare the lease in default and draw on the L/C is reduced.

Strong support for the independence and separation of the primary obligation of the issuer under an L/C from the underlying transaction that it secures or supports is found in Article 5 of the UCC, the two primary conventions governing letters of credit—the Uniform

Customs for Documentary Credits and the International Standby Practices—and case law. Under the independence principle, the *ipso facto* clause should not apply because the draw on the L/C is against the issuer, the draw proceeds are not property of the estate, and accordingly the draw should not be governed or constrained by provisions of the Bankruptcy Code that may limit or prohibit actions against the bankrupt tenant or its property.

Disregarding the independence principle, however, a bankruptcy court in New Hampshire recently enjoined a landlord from drawing on an L/C securing the bankrupt tenant's lease obligations because the only breach of the lease was the tenant's bankruptcy. *In re Metrobility Optical Systems, Inc.*, 268 B.R. 326 (Bankr. D.N.H. 2001). Significant cases hold to the contrary in the context of L/C-backed municipal bond financings, and the case in question is coming under heavy criticism. See, e.g., John Dolan, *Bankruptcy Court Corrodes Independence of Standby Credit*, Letters of Credit Web Rep. (A.S. Pratt & Sons), available at www.lettersofcreditonline.com (last visited Mar. 6, 2002).

Avoids Preferences

Draws on an L/C are normally not deemed preferential if the L/C was obtained either contemporaneously with the tenant's entry into the lease or after the lease commenced but before the preference period. If the tenant is late in paying its rental and other payment obligations under the lease within the 90-day preference period and the landlord must return them as a preference, the L/C, if not expired, can be drawn upon to make up the repayment. In fact, the existence

A landlord's secured lender should take a keen interest in the landlord's right in security deposits pledged by the landlord's tenants.

of the L/C in that circumstance may avoid the preference challenge in the first place because the debtor-tenant's estate will be no better off if it seeks to recover the preference. Late payments made up by draws on the L/C are not subject to recovery as a preference because the proceeds of the draws are not property of the estate.

Landlord's Lender Letter of Credit Issues

A landlord's secured lender should take a keen interest in the landlord's rights in security deposits pledged by the landlord's tenants. If the landlord's portfolio of leases secures the lender's loans to the landlord, and the L/Cs secure tenant obligations under those leases, those L/Cs form an important element of the secured lender's collateral from its landlord-borrower. Accordingly, the secured lender will want to (1) perfect its security interest in the L/Cs, (2) be able to obtain control of them in the event of a landlord default of the loan, and (3) establish a protocol for when they may be drawn upon and how the proceeds of the draw will be used.

Former Article 9

Before the enactment of Revised Article 9 of the UCC, the procedure for obtaining a security interest and control over L/C collateral consisted of either having it transferred into the name of the secured creditor if it was transferable, or, if it was not transferable or transferred, taking possession of the original L/C and obtaining pre-executed undated draw documents from the landlord to be held until an event occurs that entitles

both the landlord and the secured lender to draw upon the L/C. In the latter case, the landlord's lender should have been granted authority in the security documents to complete the draw documents, date them, and present them if the tenant defaulted.

Assignment vs. Transfer

Lenders and landlords should be aware of the differences between an assignment of proceeds of an L/C and a transfer of the L/C. The former is accomplished by an acknowledgment of the issuer, on a standard form of the issuer, that the assignee is entitled to be paid a designated portion or all of the proceeds of a draw on the L/C. A transfer of an L/C actually transfers the right to draw on the L/C, sign draw documents, consent to amendments, and make assignments of proceeds. As noted above, an L/C is not transferable unless it is so designated or the issuer otherwise consents to the transfer with the authorization of the applicant. An assignment of proceeds gives the assignee no right to draw on the L/C and is subject to the rights of prior assignees, transferee beneficiaries, paying and negotiating bank rights, and the set-off rights of the issuing bank.

Under Former Article 9, if the L/C were not transferred into the secured lender's name, the landlord's lender could obtain a security interest in it only by taking possession of it. See Former § 9-305. This was true even if the L/C was not a presentment credit. Maintaining possession of the L/C gave the landlord's lender priority over the bankruptcy trustee in the event of the landlord-borrower's bankruptcy, but it

gave the landlord's lender very little control over when and if a draw would be made, where the proceeds would be deposited, or even to whom the proceeds would be payable if the landlord chose to assign the proceeds elsewhere.

Revised Article 9

Under Revised Article 9, the landlord's lender can perfect a security interest in the proceeds of a draw on an L/C by obtaining from the issuer an acknowledgment of assignment of the L/C proceeds under UCC § 5-114(c). See Revised §§ 9-107, 9-312(b)(2), 9-314(a), (b). As noted above, the issuer need not consent to or acknowledge an assignment of proceeds to the landlord's lender unless the L/C is a presentment credit and the mortgage lender consents to the issuer's reasonable conditions of assignment. Although such an assignment will have priority over the bankruptcy trustee as well as the tenant's rights to the proceeds, as noted above, the landlord's lender with an assignment of proceeds but not a transfer of the L/C will be subject to the landlord's decision and ability to make a timely and conforming draw on the L/C and to the rights of prior assignees, transferee beneficiaries, confirming, negotiating and other paying banks, and set-off by the issuer for claims it may have against the landlord.

Under Revised Article 9, mortgage lenders to landlords are at a disadvantage to personal property lenders when it comes to perfecting a security interest in L/C rights. A personal property secured lender can obtain automatic perfection in L/C rights without having to obtain an acknowledgment of assignment of proceeds from the issuer. Revised Article 9 of the UCC grants the personal property secured lender a perfected security interest in L/C rights if it has a perfected security interest in the underlying personal property collateral secured or "supported" by the L/C, such as an account, an instrument, a loan not evidenced by an instrument, or another general intangible. See Revised §§ 9-102(a)(7.7), 9-203(f), 9-308(d). A mortgage lender to the landlord has a mortgage lien on and assignment of rents in

the mortgaged premises and the tenant leases. That collateral is not personal property of a type in which a supporting obligation arises under Revised Article 9. Therefore, to obtain a perfected security interest in the L/C rights, the landlord's mortgage lender will have to obtain from the issuer an acknowledgment of assignment of the proceeds of the L/C.

Use of Pre-signed Documents

If the landlord's lender can obtain neither a transfer of the L/C nor an assignment of the proceeds, in either case consented to by the issuer, it can still try to obtain control over the L/C proceeds by the use of presigned documents and a payment direction. This method, however, may not always work if the issuer finds out about it and refuses to recognize it or the landlord files for bankruptcy before the draw is made or within the preference period thereafter. The most secure, but not necessarily the most desirable, procedure for the landlord's lender is still to obtain a transfer of the L/C, which will give the landlord's lender the ability to effect draws and will give its claim priority over other assignees and set-off rights of the issuing bank.

Misuse of Draw Privileges by Landlord's Lender

If the landlord's mortgagee or secured lender has required either a transfer of the L/C or the use of presigned draw documents that the lender can submit to the issuer, the lender runs the risk of submitting draw documents that are

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premised on a tenant (not landlord) default at a time when the tenant is not actually in default. Under these circumstances, the lender runs the risk of being accused of effecting or making a wrongful draw. It can be liable for damages and attorney fees, and if done knowingly in some jurisdictions can be liable for punitive damages as well. The landlord's lender is not the best party to determine or take responsibility for determining when a tenant is in default, although in most cases that determination may be clear-cut, such as failure to pay rent. Some view this added liability as reason enough for the lender to take only an assignment of proceeds and not to involve itself in making the draw.

Revised Article 9 Transition Issues

If the landlord's lender perfected its security interest in L/Cs issued to the landlord-borrower before Revised Article 9 by possession of the original L/Cs, such possession will no longer be sufficient under Revised Article 9. Instead the

lender must obtain an acknowledgment of assignment of proceeds from the issuer within the one-year transition period provided by Revised Article 9 or obtain a transfer of the L/C into its name. Otherwise, after the one year transition period, the secured lender's interest will be unperfected. That one-year period runs from the effective date of Revised Article 9. In 46 states in which Revised Article 9 is in effect, that one-year period will end on July 1, 2002. For L/C transactions governed by Connecticut law, it will end on October 1, 2002. For lenders whose transactions are governed by the laws of Florida, Mississippi or Alabama, that one year period will end on January 1, 2003.

Conclusion

This article has discussed the advantages of letters of credit to landlords and their lenders in lease transactions. Part II, to be published in a subsequent issue of *Probate & Property*, will offer suggestions for drafting. ■



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