Additional Risks Landlords Should Consider When Taking Letters of Credit From Commercial Lease Tenants

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The authors review the benefits and risks of standby letters of credit and the prophylactic measures that a landlord can take when obtaining a standby letter of credit as security for a tenant's obligations under a commercial lease.

In the last decade, commercial landlords have favored obtaining from tenants standby letters of credit over security deposits because standby letters of credit provided added security in the event of a tenant's bankruptcy. The financial instability of banks that issue standby letters of credit and the erosion of the benefits of standby letters of credit in recent bankruptcy court decisions have reduced some of the benefits of standby letters of credit in the commercial lease context.

This article describes the benefits and risks of standby letters of credit and the prophylactic measures that a landlord can take when obtaining a standby letter of credit as security for a tenant's obligations under a commercial lease.

A Standby Letter of Credit May Be Worthless If the Issuing Bank Fails

The Federal Deposit Insurance Corporation (''FDIC'') oversees the insurance funds for banks and for savings and loan associations (also known as thrifts) and also acts as receiver for failed federally insured depository institutions. When a depository institution fails, in many instances, the FDIC negotiates a purchase and assumption transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities. As part of the purchase and assumption transaction, the purchasing institution may assume standby letters of credit issued by the failing bank.

In its role as receiver, the FDIC liquidates any remaining failed institution assets and distributes any proceeds of the liquidation to creditors of the bank or thrift, using a statutory priority scheme. As receiver, the FDIC also has the broad discretion to repudiate, within a ''reasonable period'' of its appointment, any ''burdensome'' contract that would promote the orderly administration of the receivership estate. The receivership estate may be liable for damages resulting from the repudiation of a contract, but those damages are limited to actual, direct compensatory damages determined as of the date of the receiver's appointment.

The FDIC takes the position that standby letters of credit are contingent obligations, unless the standby

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letter of credit confers on the beneficiary the right to draw on the standby letter of credit as of the date of the appointment of the FDIC receiver.[1] The FDIC's position, generally, is that contingent obligations do *not* give rise to actual, direct compensatory damages against the receivership estate—regardless of whether the tenant's obligation to reimburse the bank is secured by collateral of the tenant—and thus there is no claim by the beneficiary against the receivership estate. While deposit accounts of a federally insured depository institution are insured for up to $250,000, letters of credit are ordinarily not considered deposit accounts of the failed bank.

The Benefits of Standby Letters of Credit in a Tenant's Bankruptcy

When a tenant files for bankruptcy, the tenant/debtor (or the court-appointed bankruptcy trustee, as the case may be) has the power to reject an unexpired commercial lease for real property. The lease is deemed breached, and the landlord has a claim against the tenant's bankruptcy estate for damages for breach of the lease. The Bankruptcy Code limits the amount of a landlord's claim for lease rejection damages. A landlord's claim for damages resulting from the rejection of a lease of real property is limited to the sum of: (A) ''the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—(i) the date of the filing of the [bankruptcy] petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered the leased property;'' plus (B) ''any unpaid rent due under such lease, without acceleration, on the earlier of such dates.''[2] The landlord's claim for lease damages is unsecured unless the tenant has provided collateral to secure its performance of the lease.

Treatment of Security Deposits in a Tenant's Bankruptcy

A security deposit held by a landlord may be setoff against its lease damages claim against the bankrupt tenant and is treated as a secured claim to the extent of the setoff. Of course a landlord may not setoff the security deposit against its damages until the landlord obtains relief from the bankruptcy automatic stay (or the automatic stay is otherwise terminated).

It is well-settled bankruptcy law that a security deposit must be applied to reduce a landlord's capped bankruptcy claim against the bankrupt tenant. In other words, a security deposit is not in addition to the landlord's capped lease damages claim. To the extent that the security deposit exceeds the landlord's capped lease damages claim, the landlord must return the excess security deposit to the tenant's bankruptcy estate. For example, if a landlord has an actual damages claim of $1 million but only a $500,000 capped claim against the tenant's bankruptcy estate for lease rejection damages and the landlord holds a $750,000 security deposit, the landlord has a secured claim against the tenant's bankruptcy estate for $500,000, an unsecured claim of zero, and the landlord must return the remaining $250,000 security deposit to the tenant's bankruptcy estate.

Treatment of Letters of Credit in a Tenant's Bankruptcy

As a general rule, letters of credit are not affected by the tenant's bankruptcy filing. Neither a letter of credit nor its proceeds are property of the tenant's bankruptcy estate. Letters of credit that secure performance under a lease can be drawn if the tenant files bankruptcy—the automatic stay does *not* prevent post-bankruptcy draws on a letter of credit. Letters of credit are governed by the independence principle, which holds that the obligations of the bank to the landlord are entirely independent of the obligations of the tenant to the landlord.

Relying on this independence principle, in the last decade, landlords began obtaining from tenants standby letters of credit instead of security deposits so that landlords could maximize their recovery of lease rejection damages in the event of the tenant's bankruptcy. The theory was that since standby letters of credit are independent of the tenant's obligations, a landlord may draw down and keep the entirety of the standby letter of credit proceeds (to the extent of its damages under state law)—even if the letter of credit proceeds exceed the otherwise capped claim in the tenant's bankruptcy—and also retain a capped claim in the tenant's bankruptcy case to the extent the letter of credit proceeds were insufficient to satisfy the landlord's total damages.

In the last few years, numerous courts have held that, despite the independence principle, standby letter of credit proceeds are applied against a landlord's bankruptcy-capped claim.[3] However, the Fifth Circuit Court of Appeals, in *In re Stonebridge Technologies, Inc.*,[4] held that if a landlord has *not* filed a claim in the tenant's bankruptcy, then the landlord can retain all of the standby letter of credit proceeds *even if* the letter of credit proceeds exceed the Bankruptcy Code's cap on lease damages claims. The *Stonebridge* court reasoned that because the landlord in that case did not file a claim in the tenant's bankruptcy case, the bankruptcy cap was not triggered. Because the landlords in the *PPI* and *AB Liquidating* cases did file claims in the respective tenants' bankruptcy cases, those courts could still adopt the reasoning of the *Stonebridge* court and remain consistent with their earlier rulings.[5]

The Advantages of Obtaining a Standby Letter of Credit Versus a Security Deposit in a Bankruptcy by the Tenant

- If the tenant files bankruptcy in a circuit that has yet to decide the capped claim issue, the bankruptcy court may find that standby letter of credit

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proceeds are *not* applied against the Bankruptcy Code cap, relying on the independence principle associated with letters of credit. The circuit-level courts in only a few jurisdictions have considered this issue. Accordingly, a landlord would have the advantage of a further recovery for lease rejection damages in the event of the tenant's bankruptcy. However, so far no circuit has ruled that the landlord's draw on a letter of credit in excess of the statutory cap may be retained by the landlord except in the *Stonebridge* case. The courts tend to implement the Bankruptcy Code's policy of not letting the large size of a landlord's damages claim overwhelm the other creditors' claims in the case.

- If the standby letter of credit proceeds exceed the Bankruptcy Code cap on lease damages and the landlord does *not* file a claim in the tenant's bankruptcy, even in the Third and Ninth Circuits, such courts may adopt the *Stonebridge* court reasoning and allow the landlord to retain all of the standby letter of credit proceeds to the extent of its lease damages under state law.
- In any event there is one clear benefit from a standby letter of credit. It allows a landlord to draw on a letter of credit without being delayed by the need to first seek relief from the automatic stay imposed with the tenant's bankruptcy filing.
- A landlord can manage the risk of a failing issuing bank by including prophylactic provisions in the lease (described below) and monitoring the financial condition of the bank.

The Disadvantages of a Standby Letter of Credit Versus a Security Deposit in a Bankruptcy by the Tenant

- If the bank issuing the standby letter of credit fails and the FDIC receiver repudiates the standby letter of credit, the landlord may be left with a contingent claim worth zero. Even if the landlord monitors the issuing bank and demands a replacement letter of credit from a new issuing bank, the tenant's financial condition may have deteriorated to a point where no new bank would issue a replacement standby letter of credit and the tenant cannot post a security deposit of its own.
- It can be expensive and time-consuming for the landlord to continuously monitor the financial condition of the numerous financial institutions that have issued standby letters of credit under various commercial leases. The landlord may also have difficulty obtaining information regarding the financial condition of issuing banks.

Provisions to Include in a Lease If a Landlord Takes a Standby Letter of Credit as Security

- The landlord has the right to approve the bank issuing the standby letter of credit—either within the landlord's sole discretion or in the landlord's reasonable discretion subject to certain financial criteria, such as minimum net worth and debt or deposit ratings by private rating agencies.[6]
- The landlord has the right to demand a replacement standby letter of credit (that meets landlord's approval as described above) if the financial condition of the issuing bank deteriorates based on certain financial criteria. The landlord may draw down the existing standby letter of credit if the tenant does not replace the standby letter of credit within a certain number of days after the landlord makes demand.
- If the issuing bank is placed into FDIC receivership, the landlord has the right to demand that the tenant replace the existing standby letter of credit with a new standby letter of credit (that meets landlord's approval described above) within a certain number of days.

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[1] Typically, a standby letter of credit requires the occurrence of a default of the tenant's underlying obligation in order for the beneficiary to draw on a standby letter of credit.

[2] Under the Bankruptcy Code, the landlord has an administrative priority claim for rent and other charges arising from use of the premises from the bankruptcy petition date until the effective date of rejection of the lease.

[3] *See, e.g.*, *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 210 (3rd Cir. 2003); *In re AB Liquidating Corp.*, 416 F.3d 961 (9th Cir. 2005).

[4] 430 F.3d 260 (5th Cir. 2005).

[5] Failing to file a proof of claim in the tenant's bankruptcy may not solve the issue if the tenant or bankruptcy trustee, as the case may be, is diligent. The Bankruptcy Code and Rules allow the tenant/bankruptcy trustee to file a proof of claim in the bankruptcy case on behalf of a creditor within 30 days after claims bar date.

[6] *See, e.g.* Fitch Ratings Ltd. (www.fitchratings.com), Moody's Investors Services (www.moodys.com), and Standard & Poor's Financial Services (www.standardandpoors.com). The government regulatory agencies' ratings of a financial institution's overall condition (known as CAMELS ratings) are not released to the public. The FDIC does publish information regarding current enforcement actions on its Web site: http://www.fdic.gov/bank/individual/enforcement.

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