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Letters of Credit

Increasingly Popular, They Have Many Uses

Letters of credit have become staples of transactional real estate. Over the past several years, letters of credit have increasingly been used in lieu of cash security deposits under commercial leases. Letters of credit have also found application as earnest money deposits under contracts of sale and, occasionally, as credit support for mortgage loans.

Letters of credit are not always favored, however, due to the significant costs (some percentage of the face amount of the letter of credit) and the collateral requirements to induce the issuing bank (referred to as the "issuer") to issue the letter of credit.

A letter of credit facilitates a transaction by allowing an obligor (referred to as the "account party") to substitute the credit of an institutional lender for the obligor's credit. To a beneficiary, a letter of credit is almost as good as cash, subject only to the credit risk of the issuer, which is usually not an issue. Moreover, where the issuer is not acceptable to the beneficiary because of concerns about credit or otherwise, a confirming bank may be brought into the transaction.

A letter of credit reflects the "independence principle," whereby the issuer's obligation to the beneficiary is independent from the agreement between the beneficiary and the account party. The issuer's payment obligation is unaffected by any legal process against the account party or any bankruptcy of the account party. Moreover, a defense to payment that the account party may have against the beneficiary pursuant to the underlying agreement will not be applicable to the issuer's obligation to fund a draw under the letter of credit.

Letters of credit are currently governed by the Uniform Customs and Practices for Documentary Credits (International Chamber

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TRANSACTIONAL MATTERS

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of Commerce, 1993) (the "UCP") and Article 5 of the Uniform Commercial Code (the "UCC").

The UCP is a set of conventions applicable to letters of credit that, while not otherwise legally binding, are generally recognized in the industry and usually incorporated by reference in letters of credit. The International Chamber of Commerce has also promulgated the International Standby Practices ("ISP"), a set of conventions specifically directed to standby letters of credit, but the ISP has yet to take hold in the banking community.

The letter of credit transaction is triangular, involving mutual obligations among an issuer, an account party and a beneficiary. Each of these parties has an independent contractual arrangement with each of the others.

The letter of credit is the arrangement between the beneficiary and the issuer: an unconditional obligation on the part of the issuer to pay up to a maximum amount, the face amount, to the beneficiary upon presentation by the beneficiary of stipulated documents.

The letter of credit is procured by an account party pursuant to — and to secure obligations under — a separate underlying agreement with the beneficiary, such as a lease.

The third agreement in the letter of credit arrangement is the reimbursement agreement, under which the account party agrees to reimburse the issuer for draws that the issuer honors. The reimbursement obligations are usually secured by cash collateral, securities or other collateral, although they may also be unsecured.

Subject to delivery of the required documentation, the obligation of the issuer to fund a draw is unconditional. Under the UCC and the UCP, upon presentation of a draw request, the issuer has up to seven banking days either to accept or reject the draw request, specifying the basis for rejection. Beneficiaries and issuers both tend to prefer a "clean" letter of credit, under which the only condition to funding is presentation of a sight draft from the beneficiary.

Under the UCC and the UCP, issuers are not required to fund draw requests unless they are in strict compliance with the terms of the letter of credit, so all required documents must be presented and must be precisely in the stipulated forms. The letter of credit is subject to rigid and literal interpretation, and the function of the issuer in reviewing a draw request is intended to be ministerial. Consequently, beneficiaries seek to limit the potential for errors in a draw request by limiting required documentation.

Account parties often negotiate the requirement that the beneficiary present, with the sight draft, a certificate that the beneficiary is entitled to draw as the result of a default by the account party under its agreement with the account party. Although the ability to draw is still within the beneficiary's power, a certificate at least encourages the beneficiary to be sure that it is entitled to draw before doing so. The issuer will never (and is not entitled or required to) determine whether an account party is in default, and will only determine whether a draw request is in compliance with the letter of credit. In the event of a wrongful draw, the account party's recourse is not to the issuer, but instead consists of a breach of contract claim against the beneficiary.

Letters of credit typically have terms of one year and may not be withdrawn or terminated by the issuer before the expiry date. Many letters of credit are so-called evergreen letters of credit, which renew automatically unless the beneficiary is notified by the issuer within some period (often 60 days) prior to the expiry date that the issuer does not plan to renew the letter of credit. During this notice period, the beneficiary is entitled to draw if the account party does not provide a replacement letter of credit, and the agreement between the account party and the beneficiary usually so provides.

With respect to both fixed term letters of credit and evergreen letters of credit, the agreement between account party and beneficiary should also provide for replacement or renewal of the letter of credit, restoration of the letter of credit in the event of a full or partial draw, and permissible applications of proceeds by the beneficiary.

A point overlooked by many practitioners is that letters of credit generally are issued solely to the named beneficiary. Under the UCC, absent express provisions to the contrary, a letter of credit is not transferable, even when the beneficiary (such as a lessor) transfers its interest. Under the UCP, transferability requires that the letter of credit specify that it is "transferable," and even a statement that it is "assignable" will not suffice. Issuers usually impose a transfer fee upon consummation of any such transfer.

Furthermore, the UCP provides that absent express provisions to the contrary, a transferable letter of credit may only be transferred once. In order to allow for serial transfers, the beneficiary should either ensure that the letter of credit specifically permits multiple transfers or include in the lease or other underlying agreement a requirement for replacement of the letter of credit upon demand after the first transfer.

A principal advantage of a letter of credit as security for a lease, loan or other obligation is that, in the event of the account party's bankruptcy, the letter of credit and its proceeds are not considered property of the account party's estate. In addition, as noted above, a letter of credit is subject to the "independence principle," which treats the issuer's obligation to the beneficiary as independent from the underlying contract between the beneficiary and the debtor. Accordingly, a draw under a letter of credit will not, as a general matter, be subject to the automatic stay in the account party's bankruptcy proceeding.

However, where a draw is conditioned on the beneficiary's certification that it has taken an action -— for example, making a demand on the debtor -— that is precluded by the automatic stay, then, as a practical matter, the beneficiary will be unable to draw on the letter of credit because it will not be able to make the required certification.[1]

That a letter of credit may be drawn despite the account party's bankruptcy does not insulate the beneficiary from complications that may arise from a bankruptcy. In the case of a letter of credit given as security under a lease, the amount that may be retained by the lessor from the proceeds of a letter of credit may, in the event of the lessee's bankruptcy, be subject to the cap on damages prescribed by 11 U.S.C.S. §502(b)(6) -— i.e., (A) the rent reserved by the lease, without acceleration, for the greater of one year or 15 percent of the remaining term of the lease (not to exceed three years' rent) following the earlier of the filing of the petition or the date on which the lessor repossessed, or the lessee surrendered, the leased premises plus (B) unpaid rent due under the lease, without acceleration, on the earlier of such dates.[2] In *Faulkner v. EOP-Colonnade of Dallas*, LP (*In re Stonebridge Technologies, Inc.*), 291 B.R. 63 (Bankr. N.D. Tex 2003), the court ruled that proceeds of a letter of credit drawn by the lessor in excess of the capped damages must be paid to the trustee.

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The court in *Stonebridge* treated the proceeds of a letter of credit in the same manner as a security deposit and followed a line of prior cases holding that a lessor may not retain a security deposit made by the bankrupt lessee to the extent the deposit exceeds the allowable claim.[3] In another case, *Solow v. PPI Enterprises (U.S.), Inc.* (*In re PPI Enterprises (U.S.), Inc.*), 324 F.3d 197 (3d Cir. 2003), the court — holding, like the *Stonebridge* court, that letter of credit proceeds should be treated like a security deposit — concluded that such proceeds should be applied against the statutory cap on damages and should not be treated as providing the lessor with a separate form of recourse not subject to the cap.[4]

Both *Stonebridge* and *PPI Enterprises*, while recognizing that the automatic stay does not apply to draws on letters of credit, treat the proceeds as property of the debtor for purposes of the statutory limitation on damages. These cases therefore treat such proceeds differently from payments under a third party guaranty, which are not applied against the §502(B)(6) cap.

The recent opinion by the Bankruptcy Appellate Panel of the Ninth Circuit in *Redback Networks, Inc. v. Mayan Network Corporation* (*In re Mayan Networks Corporation*), 2004 Bankr. LEXIS 184 (B.A.P. 9th Cir. 2004) follows a somewhat different line of reasoning in its treatment of proceeds received under a letter of credit in bankruptcy.

In the *Mayan* case, the reimbursement obligation of the lessee to the issuer was secured with cash.[5] The court held that in such a case —where the issuer is "fully protected if it had to pay on the letter of credit" — there is no third party who bears any substantial risk in connection with a draw on the letter of credit and the arrangement is tantamount to a security deposit (with the issuer "inserted" between the lessee and the lessor).

Accordingly, the court concluded that the amount drawn on the letter of credit should be applied against the statutory cap. The court drew a distinction between the *Mayan* case and the facts presented in *CEI Systems, Inc. v. Condor Systems, Inc.* (*In re Condor Systems, Inc.*), 296 B.R. 5 (B.A.P. 9th Cir. 2003) (a case involving the cap on damages for termination of employment agreements under §502(b)(7) of the Bankruptcy Code), in which the debtor's reimbursement obligation to the issuer was not secured.

In the court's view, a draw on the letter of credit in *Condor* had no adverse effect on the debtor's estate (unlike the draw in *Mayan*, which gave the issuer the right to realize on collateral provided by the debtor) and the letter of credit was therefore more akin to a third-party guaranty than to a security deposit.

The practical effect of *Mayan* and any other decisions that adopt its rationale may be that the determination of whether a letter of credit will be treated like a security deposit — and will therefore be subject to the statutory cap on lease damages — will turn on whether the lessee's reimbursement obligation to the issuer is secured or unsecured. This approach, while it may more nuanced than the approach taken in PPI or Stonebridge, does not provide a great deal of comfort to the lessor, since under the court's reasoning the result to the lessor will depend on arrangements between the lessee and the issuer over which the lessor will generally have little control.[6]

1. *Kellog v. Blue Quail Energy, Inc.* (*In the Matter of Compton Corp.*), 831 F2d. 586 (5th Cir. 1987).
2. 11 U.S.C.S. §502(b)(6) (LEXIS through 2004).
3. *Stonebridge*, 291 B.R. at 68.
4. *PPI Enterprises*, 324 F3d. at 207-10.
5. *Mayan Networks*, 2004 Bankr. LEXIS at *2.
6. See Daniel J. Carragher, Courts Limit Benefits to Landlords under Letters of Credit, Am. Bankr. Inst. J., July 2003, at 126 and Peter J. Gregora, Letters of Credit in Mortgage Financing, in 1 Commercial Real Estate Financing 2004: What Borrowers and Lenders Need to Know Now 423 (Joshua Stein & Pamela J. Westhoff co-chairs, 2004) for a more extensive discussion of letters of credit in the context of a tenant's bankruptcy.