

2012 ICSC US Shopping Center Law Conference Roundtable

USING LETTERS OF CREDIT FOR TENANT CREDIT ENHANCEMENT

Presented by:

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I. Introduction.

Cash security deposits (typically in the amount of one or two month's rent) have been the traditional form of tenant credit enhancement required by commercial landlords. However, in instances where landlords feel more at risk (such as in today's uncertain economic times), landlords often seek to receive more than a cash security deposit. A letter of credit is a common alternative or additional enhancement, and in some instances, may be favored over a cash security deposit. A letter of credit is an instrument in which an issuing bank, at a customer's (tenant's) request, agrees to honor a draft or other demand for payment made by a third party (landlord) as long as the demand complies with specified conditions. In essence, the bank's creditworthiness is substituted for that of its customer and the credit risk is shifted to the issuing bank.

II. Credit Enhancement for a Commercial Lease.

A. ***Standby Letters of Credit*** - An irrevocable, standby letter of credit is the standard form that this instrument takes in the context of security for a commercial lease. Unlike the commercial letter of credit, the standby letter of credit functions as an assurance of payment rather than a source of payment and is meant to be drawn upon only if a default occurs.

- The standby letter of credit should be an "unconditional, clean, irrevocable letter of credit". Additionally, it should be clear that the letter of credit is transferable for the benefit of a future purchaser or the landlord's lender in the event the property is sold or otherwise transferred during the tenant's lease term.
- In addition to Article 5 of the UCC, standby letters of credit used as a tenant credit enhancement for a lease should refer to the International Standby Practices 1998 (ISP98) (the standard reference for standby letters of credit).

B. ***Letter of Credit in Lieu of a Cash Security Deposit*** - If the monthly rent due under the lease is a very large amount, or for a start-up business with limited cash, a landlord may consider requiring a letter of credit as an alternative to a cash security deposit.

C. ***Letter of Credit to Secure Landlord's Up-Front Out-of-Pocket Leasing Costs*** – If a landlord has concerns over the tenant's continuing creditworthiness, a cash security deposit of one or two month's rent may not provide adequate recovery for the landlord upon a tenant default. The landlord may want to consider requiring a tenant with marginal credit to provide a letter of credit in an amount adequate to cover the landlord's up-front leasing costs, such as brokerage commission, tenant improvement allowances, or the landlord's build-out costs, to provide a certain source of recovery if the tenant defaults. In this case, the landlord's exposure for up-front leasing costs reduces over time as the tenant pays rent under the lease. As a result, it may be appropriate to provide that the amount of the security requirement is reduced over time to correspond with the amortization of the landlord's up-front leasing costs.

III. Additional Considerations and Potential Risks.

A. ***Draw Requirements*** - From the landlord's perspective, the requirements to draw on the letter of credit should be as clear and direct as possible so that no issues arise when the draft is submitted to the issuing bank. Typically, the only obligation of the landlord to draw on the letter of credit should be the presentation of the original letter of credit and the landlord's certification that the tenant is in default under the lease. The landlord should take care to ensure that the conditions of draw can all be met unilaterally by the landlord without any cooperation from the tenant and despite a tenant bankruptcy filing. For example, if the letter of credit requires a copy of the landlord's payment demand to the tenant and the automatic stay of bankruptcy precludes issuance of such a demand, the landlord may be unable to fulfill the draw requirements.

B. ***Expiration; Renewal and "Evergreen Clause"*** - A typical letter of credit is issued for a 12 month period, but leases often require that the letter of credit remain in place for the full term, as much as 10 years or more. To address this, the letter of credit may include an "evergreen clause", by which the letter of credit will automatically renew each year during the lease term unless the issuing bank gives the landlord notice that it will not renew the letter of credit; if the bank elects not to renew, the landlord would then have an immediate, unconditional right to draw (i.e., no need for the tenant to be in default). Ideally, the final extension of the letter of credit should remain in effect for a period of time after lease expiration to allow time for any reconciliation of operating expenses and to cover damage incurred upon tenant's move out of the premises.

C. ***Failure of Issuing Bank*** - The FDIC has advised that it will not honor letters of credit issued by banks which have been placed in FDIC receivership. In those instances, all the benefits that a landlord believed that it had from holding a letter of credit will disappear. In light of this, the landlord should accept a letter of credit only from a financial institution with verified financial stability. During the lease term, the landlord should monitor the continuing stability of the financial institution and if necessary (and if possible to negotiate) require a tenant to obtain a new letter of credit from a more secure financial institution if the original issuing bank's situation begins to deteriorate. Lease provisions should provide that if the financial institution which issued the initial letter of credit is declared insolvent by the FDIC or is closed for any reason, the tenant must immediately provide a substitute letter of credit from a financial institution acceptable to the landlord.

D. **Bankruptcy Considerations** - Landlords and tenants should be aware of how the application of certain provisions of the Bankruptcy Code, such as the automatic stay, cap on landlord's damages, and the rules regarding voidable preferences, may alter the parties' expectations in regard to the letter of credit.

- **Independence Doctrine** – Letters of credit are said to be governed by the “independence doctrine”, which is typically understood to mean that the issuing bank’s obligation to fund a duly presented draw request is entirely independent of the underlying lease transaction. The purpose of a letter of credit is to assure payment when its own conditions have been met, irrespective of disputes that may arise between the parties concerning performance of other agreements which comprise the underlying transaction.
- **Tenant Bankruptcy** – Under the precepts of the independence doctrine, the letter of credit and its proceeds are not properly the property of the tenant’s bankruptcy estate, and a tenant’s filing of bankruptcy should not affect the letter of credit. However, in recent years various courts have sought to weaken the independence doctrine, particularly in the context where the draft on the letter of credit would indirectly result in impairment of assets in the bankrupt tenant’s estate.
- **The Automatic Stay; Timing of Draw on Letter of Credit** - The automatic stay does not typically prevent a landlord from drawing on the letter of credit after a tenant files bankruptcy. However, if a condition precedent to drawing on the letter of credit is presentment of an invoice or demand to the debtor and such notice has not been given prior to bankruptcy, the automatic stay may come into play. Care must be taken to avoid requirements that a collection-type notice be sent to the debtor prior to the draw. Drawing on a letter of credit does not violate the automatic stay but a condition precedent to draw such as demand on the debtor may.
- **Cap on Landlord’s Damages** – If the tenant files bankruptcy and rejects the lease, the landlord will be limited in its recovery due to the cap on lease rejection damages under Bankruptcy Code Section 502(b)(6). Under that section, a landlord’s damages recoverable from a bankrupt tenant will be limited to (1) the remaining rent under the lease, limited to the greater of one year or 15% of the remaining term, not to exceed three years, calculated from the earlier of the pre-petition date or the date the landlord regained possession of the property, plus (2) unpaid rent which had accrued prior to that date. This bankruptcy cap on damages may limit the amount the landlord may retain out of a draw on a letter of credit. In other words, while it may be permissible for the landlord to draw down the entire letter of credit proceeds, the landlord may still be called upon to disgorge some portion of those proceeds if they exceed the amount of the bankruptcy cap. It is well established that a security deposit must be applied to reduce a landlord’s capped bankruptcy claim. It is not so clear how a letter of credit should be treated in a tenant bankruptcy. Courts have held that, despite the independence doctrine, standby letter of credit proceeds are limited to a landlord’s capped claim. Although only a few jurisdictions have considered the issue, bankruptcy judges tend to implement the

Bankruptcy Code's policy of not letting the large size of a landlord's claim overwhelm the claims of the tenant's other creditors.

- *In re PPI Enterprises (U.S.), Inc.* – The U.S. 3rd Circuit Court of Appeals determined that the language of the lease in question expressly required the debtor to provide a standby letter to landlord instead of a cash security deposit. As the parties intended the letter of credit to serve as a security deposit, any draw amounts received should reduce the landlord's capped claim.
- *In re Stonebridge Technologies, Inc.* – By contrast, the U.S. 5th Circuit Court of Appeals 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 proceeds exceed the bankruptcy cap.

The courts that determined that the proceeds from a letter of credit are subject to the Bankruptcy Code's cap on landlord's damages have generally placed great emphasis on the lease provisions that specified that the letter of credit would be used in place of a security deposit.

- ***Planning Strategies*** – The above decisions leave open the possibility of avoiding the bankruptcy cap by characterizing the letter of credit as something other than a security deposit. A possible strategy is to structure the lease provisions so that it is clear that the letter of credit is not a form of security deposit. However, no specific alternative characterization of the letter of credit comes to mind that would not potentially jeopardize a landlord's ability to apply the letter of credit proceeds to satisfy the tenant's payment obligations if the tenant defaults under the lease. Additionally, the manner in which state laws characterize rent and deal with a landlord's recovery of leasing costs may make it difficult to determine how to alternatively characterize a letter of credit.

IV. Sample Form of Letter of Credit.

FORM OF LETTER OF CREDIT

Irrevocable Standby Letter of Credit No. _____

Place and Date of Issue:
_____, _____, _____, 201__

Date and Place of Expiry:
_____, 201__ in _____,

Applicant:

[Tenant]

Beneficiary:

[Landlord]

Amount: USD _____
(_____ Thousand and no/100 Dollars)

Ladies & Gentlemen:

We hereby establish our Irrevocable Letter of Credit in your favor available by Beneficiary's sight draft drawn on _____ [Issuing Bank's Name] _____ accompanied by the original of this Letter of Credit and the following document:

A signed and dated written statement executed by any purported officer or authorized agent of Beneficiary reading as follows:

- “[Applicant Name] (“Tenant”) is in default under that certain lease dated [Date], including any amendments and restatements thereto, between Tenant and [Beneficiary Name], as landlord (the “Lease”), and that such default exists beyond any applicable cure period provided in the Lease for such default, if any.”

OR

- “We are in receipt of notice from [Issuer's Name] that this Letter of Credit will not be extended beyond [Current Expiry Date] and [Applicant Name] has failed to supply acceptable replacement security within the time frame specified in that certain Lease dated [Date], including any amendments and restatements thereto, between [Applicant Name], as tenant, and [Beneficiary Name], as landlord (the “Lease”).”

This Letter of Credit shall have an initial expiration date as of the close of business on the date that is one (1) year from the date of issuance, but such expiration date shall be automatically extended, without further action, for additional periods of one year from the initial expiration date, unless we notify Beneficiary by certified mail (return receipt requested) at least 60 days prior to any expiration date that we elect not to consider this Letter of Credit extended for any such additional period.

[OPTIONAL – TO BE INCLUDED AS APPROPRIATE TO THE BUSINESS TERMS]

This Letter of Credit will be automatically reduced in accordance with the below schedule and contingent upon automatic extension of this Letter of Credit as herein provided.

[INSERT TABLE FOR SCHEDULE]

In the event of a drawing hereunder, the reduction amount for the subsequent period(s) will be decreased by the amount of said drawing(s). In no event will the total of all payments paid hereunder exceed U.S. \$[_____].

[OPTIONAL]

Presentation of documents by telefacsimile (“Fax”) is acceptable, and must be directed to Fax Number () ____-____. If any such demand is presented by Fax, the original draft, statement and Letter of Credit shall be simultaneously forwarded by overnight courier service to our office located at the address stated above; provided further that the failure of the courier service to timely deliver shall not affect the efficacy of the demand.

[OPTIONAL – BANK PROVISION]

This Letter of Credit sets forth in full the terms of our undertaking, and such undertaking shall not in any way be modified, amended or amplified by reference to any document, instrument or agreement referred to herein or in which this Letter of Credit is referred to or to which this Letter of Credit relates, and any such reference shall not be deemed to incorporate herein by reference any document, instrument or agreement. The obligation of *[Issuer’s Name]* under this Letter of Credit is the individual obligation of *[Issuer’s Name]* and is in no way contingent upon reimbursement with respect thereto.

We hereby engage with you that all drafts drawn under and in compliance with all the terms and conditions of this Letter of Credit will be duly honored if drawn and presented for payment between the hours of 8:00 a.m. and 4:00 p.m. Monday through Friday on a day when *[Issuing Bank’s Name]* is open for business at *[Issuing Bank’s Location]* on or before the expiration of this Letter of Credit.

This Letter of Credit is subject to the International Standby Practices – ISP98, as the same may be revised from time to time.

Partial drawings are permitted hereunder. This Letter of Credit may be transferred by Beneficiary to one or more subsequent owners of the real property which is the subject of the Lease.

[Issuing Bank's Name]

By: _____
Name: _____
Title: _____

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