

Judicial Alchemy—Spinning Letters of Credit into Security Deposits

Gary S. Kessler*

Kessler & Collins

Dallas, Texas

Introduction

Prudent landlords have long looked to third parties to supply credit enhancement for commercial leases. These sources have included guaranty contracts, insurance or surety contracts, and standby letters of credit. This protection is expressly bargained for to secure repayment of monetary inducements provided to tenants that might not be recouped, upon default and bankruptcy filing by a tenant, if the Bankruptcy Code's damage limitation was imposed. Section 502(b)(6) of the Bankruptcy Code caps the claim of a real property lessor for damages when its commercial lease is rejected.¹ Being able to avoid this cap, through the use of third-party security, enables transactions to occur that might otherwise be viewed as too risky.

By far, the most popular instrument for third-party security has been the standby letter of credit. In a standby letter of credit transaction, there are three independent agreements: The first agreement is the lease; the second agreement is between the issuing bank and the tenant, and typically provides for repayment by the tenant to the issuing bank in the event the bank makes payment under the third agreement, which is the actual letter of credit. It is under this third agreement that the issuing bank becomes primarily liable to the landlord.² The Fifth U.S. Circuit Court of Appeals in *Kellogg* described this by stating: "The shifting of liability to the bank rather than to the goods or services provider is the main purpose of the letter of credit."³

Landlords have reasonably come to believe that the standby letter of credit and its proceeds were not property of the debtor's estate. With a minor exception,⁴ landlords can draw under a standby letter of credit without fear of violating the §362 automatic stay or being enjoined under §105 of the Bankruptcy Code. This belief is embodied in the long-standing "independence principle," which views the issuing bank's obligation to the landlord as being absolute regardless of the terms of the underlying agreement or any dispute relating to such agreement.⁵

PPI Enterprises—The Beginning Thread

While it does appear that the reluctance of bankruptcy courts to interfere with payment under a standby letter of credit remains intact, two recent cases have caused substantial erosion to the benefits previously enjoyed through their use. In the first, the Third U.S. Circuit Court of Appeals determined that a landlord's capped claim should be further reduced by the amount of its draw under a standby letter of credit. *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)* 324 F.3d 197 (3d Cir. 2003). In analyzing whether to reduce the claim or allow the landlord to apply the letter of credit proceeds outside the capped damages, the court balanced the equities involved.⁶ While indicating that it might find that the equities would compel application of the proceeds to the capped damages,⁷ the court did not decide this as a general rule. Rather, the court stated: "Nonetheless, we need not decide the underlying question because it is clear the parties intended the letter of credit to operate as a security deposit." *PPI* at 210. The lease language which the court found evidenced this intent was similar to language found in many standard leases that provide for delivery of a letter of credit.⁸ This may cast doubt over the credit integrity of many leases in the marketplace today. The thoughtful planning that went into a landlord's bargain for third-party security has been disrupted by this court's inclination to discern "intent" from lease language that seemed to indicate just the opposite. Fortunately for landlords, the court stopped there. In its opinion, the court seemed to want to go beyond what was necessary to decide the case. Had it decided that letters of credit should be afforded the same treatment as traditional security deposits, it very well may have reached the issue presented in the second of these cases.

Stonebridge—The Transformation

In *PPI*, the letter of credit proceeds were not in excess of the §502(b)(6) cap. As a result, the court did not have to reach the issue of whether the landlord could draw and retain letter of credit proceeds in excess of the cap. This issue, however, was recently addressed in *Faulkner v. EOP-Colonnade of Dallas LP (In re Stonebridge Technologies Inc.)*, 29 B.R. 63 (Bankr. N. D. Tex. 2003). Pursuant to the terms of its lease, Stonebridge was required to provide security for performance of the lease to its landlord. In addition to a cash security deposit of \$105,888, it caused its bank to issue a standby letter of credit in the amount of \$1,430,065.74. To secure the issuing bank in the event of the bank's payment under the letter of credit, Stonebridge executed a note payable to the bank and secured this obligation by a certificate of deposit in the amount of \$1,250,000.00. The terms of the letter of credit provided that \$1,430,065.74 was available for payment upon submission by the landlord of a draft drawn on the bank accompanied by the original of the letter of credit and the landlord's statement that the draw represented funds due and owing as a result of the tenant's failure to comply with one or more terms of the lease. There was no requirement of notice to the tenant.

Prior to the landlord's draw under the letter of credit, the tenant had informed the landlord that it intended to reject the lease. It entered into an agreement with the landlord, which was reported to the court, that the lease would be rejected no

later than Oct. 23, 2001, and no earlier than Oct. 1, 2001. The court did not sign an order rejecting the lease until Nov. 8, 2001, but when it did so the rejection was effective as of Oct. 1, 2001. While it is not clear from the court's opinion, it is apparent that the tenant "negotiated" the retroactive rejection to minimize its administrative rent obligations. The landlord drew under the letter of credit after the agreement was announced to the court but before the order was signed. At the time of filing its bankruptcy petition in September 2001, Stonebridge had not paid its September rent.

Stonebridge's liquidating trustee sued the landlord to recover the excess of the letter of credit proceeds over the capped claim and, as assignee of the bank's claims, sued for misrepresentation in connection with the draw under the letter of credit. The court found that the landlord had breached the lease by seeking more than the capped damages in its draw under the letter of credit. It awarded the excess to the trustee as damages. Further, the court awarded the trustee, as assignee of the bank, damages as a result of initiating the draw before the court signed the order rejecting the lease. These damages were determined to be the difference between the amount of the draw and the value of the collateral that the bank was able to recover on its secured claim. What is unusual about this aspect of the decision is that it appears the bank would have been required to properly pay the landlord just two weeks later upon the court signing the rejection order.

Like the *PPI* court, *Stonebridge* looked to the lease provisions that allowed the delivery of the letter of credit to be part of the security deposit. This decision severely undermines the independence principle. Under the court's analysis, any property, guaranty or other contract denominated as security would be subject to the §502(b)(6) cap. This would include a pledge or guaranty by a third party, which was never intended to be so limited.⁹ The court stated it was not abandoning the independence principle; rather, it distinguished the principle by holding that it was merely addressing the manner in which the proceeds of the letter of credit would be applied—not how they would be distributed.

Despite this statement, it is clear the *Stonebridge* court did more. It was the distribution of the proceeds by the landlord in an amount in excess of the cap that the court found to constitute a breach of the lease. There does not appear to be authority in the Code, legislative history or any existing case law for the court's limiting a landlord's draw under a standby letter of credit or its application of such proceeds to the landlord's capped claim amount. This decision is presently being appealed.¹⁰

Conclusion

As a result of these recent decisions, care should be taken in drafting lease provisions that require delivery of any type of third-party instrument such as credit enhancement. It has been suggested that the language in a lease requiring delivery of a letter of credit be separated from the security provisions of the lease. Another interesting question that becomes apparent from a reading of the *Stonebridge* opinion is the characterization of letter of credit proceeds if a landlord draws under a letter of credit based on an issuing bank's failure to renew. Certainly, in either case, a tenant would argue that these proceeds would now be transformed into a mere security deposit for cap purposes. While careful drafting may have eliminated the problems encountered by the landlords in these cases, it is clear that courts are attempting to graft limitations on the ability of landlords to use third-party instruments to avoid the limitations of §502(b)(6). If this trend continues, it may have the unintended consequence of lessening a tenant's ability to secure monetary inducements from prospective landlords. The less confident a landlord is that it can recoup its entire investment, the more cautious it will be in making such advances.

*GARY S. KESSLER is a shareholder of the firm. He is an affiliate of BOMA, ICSC and The Real Estate Council, and is a "friend" of IREM. Mr. Kessler is a frequent speaker at IREM and ICSC conferences participating regularly at the International Council of Shopping Centers Law Conference.

¹The damage claim is capped at (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 the lease, following the earlier of the date of filing of the petition or the date on which the lessor regained possession or the lessee surrendered the premises; plus (b) any unpaid rent due under such lease at such time.

²*Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)* 831F.2d, 586 (5th Cir. 1988).

³*Kellogg* at 590.

⁴See *In re Metrobility Optical Systems, Inc.* 268 B.R. 326 (N.H. 2001).

⁵In *Kellogg*, at 590, the court held "Under the independence principle, an issuer's obligation to the letter of credit's beneficiary is independent from any obligation between the beneficiary and the issuer's customer. All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all the duties required by the letter of credit. Any disputes between the beneficiary and the customer do not affect the issuer's obligation to the beneficiary to pay under the letter of credit."

⁶See *PPI* at 209 where the court analyzed the independence principle in light of case law holding that a security deposit must be applied to the capped damages.

⁷"In one case the insurance is security put up by the tenant himself, while in the other it is the credit standing of a third party procured by the tenant; this difference is insufficient to justify divergent rule as to the respective allowable claims. If the total damages are limited in one instance, they should be limited in the other instance." *PPI* at 210.

⁸"In lieu of the cash security deposit provided for in Article 33A, Tenant may deliver to Landlord as security pursuant to Article 33A, an irrevocable, clean, commercial letter of credit in the amount of \$650,000 issued by a bank...."

⁹See *Young v. Condor Systems Inc. (In re Condor Systems, Inc.)* 296 B. R. 5 (9th Cir. BAP 2003) dealing with the cap imposed on employment claims under §502(b)(7).

¹⁰The decision has been appealed to the United States District Court for Northern District of Texas.