[9]There is nothing in the legislative history or in the Bankruptcy Code to suggest an intention to alter this practice through the enactment of the Bankruptcy Code or §365(d)(3). The Third Circuit noted that prior bankruptcy practice should not be dismissed without clear intent. However, it found that altering the treatment of landlord claims demonstrated such clear intent. It appears that the Third Circuit amalgamated the intent to change the immediate entitlement to payment for continued services with the allocation of charges between the pre-petition and post-petition periods. There is no indication of any attempt to disturb the allocation issue. *Montgomery Ward*, 268 F.3d at 215 (Judge Mansmann, dissenting).

[10]*Koenig Sporting Goods*, 203 F.3d 986; *In re Krystal Co.*, 194 B.R. 161 (Bankr. E.D. Tenn. 1996); *Inland's Monthly Income Fund, L.P.* v. *Duckwall-ALCO Stores, Inc. (In re Duckwall-ALCO Stores, Inc.)*, 150 B.R. 965 (D. Kan. 1993); *In re F & M Distributors, Inc.*, 197 B.R. 829 (Bankr. E.D. Mich. 1995); *In re Appletree Markets, Inc.*, 139 B.R. 417 (Bankr. S.D. Tex. 1992).

[11]The decision in *Montgomery Ward* recognized this potential. *Montgomery Ward*, 268 F.3d at 212.

Letters of Credit—Are They Bulletproof?

Gary S. Kessler
Kessler & Collins P.C.
Dallas, Texas

Introduction

While negotiating a lease, a tenant's credit is typically of utmost concern. This is especially so in deteriorating economic times. The use of a standby letter of credit will allow an owner to "replace" the tenant's credit with that of the issuing bank and thereby avoid a portion of its loss in the event the tenant becomes a debtor in a bankruptcy proceeding. A letter of credit is designed to provide swift and certain payment to the beneficiary. Once the beneficiary complies with the terms of the letter of credit, a party generally cannot prevent the issuing bank from distributing the proceeds. The courts refer to this as the "independence principle" because of the view that the letter of credit is an agreement between the bank and the beneficiary separate from both the underlying commercial transaction, such as a lease, and the agreement between the bank and its customer. It is generally assumed that the "independence principle" will shield an owner from being denied the right to draw under a standby letter of credit as a result of a tenant's bankruptcy filing.

A New Hampshire Bankruptcy Court has cast slight doubt on this belief in the case of *In re Metrobility Optical Systems, Inc.*, 268 B.R. 326 (2001). The court granted an injunction precluding the landlord from drawing down a letter of credit obtained from its tenant. It did not rely on the automatic stay provisions of §362 to preclude presentment under the letter of credit. Rather, the court looked to its inherent power to issue an injunction. While not citing the source of such power, it is clear that the court was relying on 11 U.S.C.A. §105(a). This section permits the bankruptcy court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." The courts have granted injunctions under this section when they find, in addition to the substantive requirements, that the failure to issue such relief would result in undue pressure on the debtor which would have an adverse impact on the debtor's ability to formulate a Chapter 11 plan.

Drafting Is Important

In this case, the debtor/tenant's lease required the issuance of a $1,792,000 letter of credit to secure its performance. The terms of the letter of credit required the landlord either to certify that the tenant had failed to pay rent or perform one or more of its obligations under the lease, or had failed to replace the letter of credit as was required under the lease. The lease provided that the landlord would not draw down the entire amount of the letter of credit "until the lease was terminated by the Lessor for default by the Lessee…" and further provided that the filing of a voluntary bankruptcy proceeding was an event of default. The tenant filed for bankruptcy, and on the following day the landlord gave its notice of default and acceleration based solely on the filing. The debtor sought to enjoin the drawing or payment under the letter of credit based on §365(e), which prohibits enforcement of *ipso facto* clauses in executory contracts, including unexpired lease. The tenant was not otherwise in default under its lease at the time of the bankruptcy filing.

The court issued its preliminary injunction, finding that the landlord could not declare the tenant/debtor to be in default solely on the basis of the *ipso facto* clause and that the automatic stay provisions in §362 rendered both the notice of termination of the lease and the acceleration of rents void. As a result, the court found that allowing the letter of credit to be drawn would result in irreparable injury because a decision to assume or reject the non-terminated lease had not been made and, further, that upon paying the letter of credit, a security interest previously granted to the issuing bank by the tenant would be funded. Thus, a secured claim would be created from what would otherwise be the landlord's unsecured claim for rent.

The *Metrobility* Court essentially merged the letter of credit and the lease. Drawing under the letter of credit was dependent on the successful termination of the lease by the landlord. It held: "In this case, the letter of credit secures the performance under a lease to which the debtor is a party, and it is pursuant to the terms of the lease that this injunction issues."

Effect of This Case

The general trend of the bankruptcy courts is to recognize the independence of the bank's obligation to the landlord from the underlying lease obligations. *See, Kellogg* v. *Blue Quail Energy, Inc. (In re Compton)*, 831 F.2d 586, 589 (5th Cir. 1987). Virtually all courts recognize that the automatic stay in §362 will not prevent a party from drawing under a letter of credit. *See, In re Guy C. Long, Inc.*, 74 B.R. 939, 943-944 (Bankr. E.D. Pa. 1987). This court presumably relied on §105 of the Bankruptcy Code to grant relief. This case is clearly distinguishable from the majority of opinions which hold that granting an injunction to preclude drawing under a letter of credit would disrupt the fundamental and long-standing principle that the bank's obligation to pay is independent of the underlying transaction. These courts have refused to enjoin the payment of the letter of credit, even though such drawing would (i) convert an unsecured claim by the landlord to a secured claim by the bank [*In re Sabretek Corp.*, 257 B.R. 732 (Bankr. D. Del. 2001)] or (ii) allegedly cause the landlord to receive more monies than allowed under the §502 (b)(6) cap. *See, In re Farm*

Fresh Supermarkets of Maryland, 257 B.R. 770 (Bankr. D. Md. 2001).

Practice Tip

It goes without saying that a landlord should seek broad rights to draw under a letter of credit. The letter of credit should specify the exact terms under which the landlord will be allowed to draw. It should not be drafted to require that the landlord give its tenant any notice or take any action to affect the lease. Also, the lease should never characterize the letter of credit or its proceeds as a security deposit. *See, In re PPI Enterprises, Inc.*, 228 B.R. 339 (Bankr D. Del. 1998). If the terms of the letter of credit in the *Metrobility* case had allowed the landlord to draw under it for an event other than the termination of the lease—such as the insolvency or bankruptcy of the tenant or as a result of the tenant's having committed an anticipatory breach—then a different outcome may have been reached.

Gary S. Kessler, Esq., is a shareholder in the Dallas firm of Kessler & Collins, whose practice includes commercial real estate and leasing. Mr. Kessler is a frequent speaker at IREM and ICSC conferences participating regularly at the International Council of Shopping Centers Law Conference.

The Death of Independent Covenants in Massachusetts

Raymond M. Kwasnick
Judith B. Miller
Goulston & Storrs
Boston, Mass.

You are a tenant in a shopping center with chronic roof leaks. You notify your landlord of the leaks on several occasions, but he fails to repair the roof properly. Although the leaks make the operation of your business less convenient and more expensive, they do not rise to the level of causing work stoppages, resulting in missed or delayed customer deliveries or otherwise preventing you from carrying on your business. Can you terminate your lease and recover relocation costs from your landlord? Assuming your lease does not provide otherwise, according to a recent decision by the highest court of The Commonwealth of Massachusetts, the Supreme Judicial Court ("SJC"), in *Wesson* v. *Leone Enterprises, Inc.* (No. SJC-0872, 2002 Mass. LEXIS 540 (2002)) ("*Wesson*"), the answer to that question is a resounding "yes."

The Facts of *Wesson*

The tenant in *Wesson* was a financial printing company in a multi-tenant building who, over the course of approximately six months, complained to the landlord about significant roof leaks. According to the trial judge, "the roof was in a state of disrepair and needed more than spot repairs" and the roof repair methods were "shoddy and unsuccessful." The tenant notified the landlord that he would be vacating the premises prior to the expiration of the term of the lease for reasons "well known to you. For a constant lack of minimal heating as well as the serious leakage problem." The landlord sued the tenant for breach of contract and damage to the premises.

The trial judge concluded that the tenant had been "constructively evicted" (discussed below) from the premises by the landlord's failure to repair the roof adequately. Since the landlord failed to provide a "dry space," a service "essential" to the lease, the trial judge alternatively held that even if the tenant had not been "constructively evicted" from the premises, the tenant could have lawfully withheld rent under the dependent covenants rule (also discussed below). The landlord appealed the trial court decision and the SJC heard the case on its own motion.

The Ruling of the SJC

Although the SJC affirmed the judgment for the tenant, it did so by adopting a new legal rule in Massachusetts. The SJC ruled in favor of the tenant—not on the basis of a constructive eviction— but rather by adopting the legal rule of mutually dependent covenants for commercial leases. As applied to this case, the rule entitled the tenant to terminate the lease and recover relocation costs because the landlord breached his covenant to maintain the roof.

In deciding the *Wesson* case, the SJC rejected the old independent covenants rule in commercial leases. Under the independent covenants rule, the obligations of the landlord and the tenant under the lease were independent so that the landlord's failure to perform one obligation did not give the tenant any right to be relieved of the other obligations under the lease. For example, under this old rule, a commercial landlord's breach of the covenant to repair the roof would not relieve the tenant of his covenant to pay rent. In *Wesson*, the SJC adopted the following rule of mutually dependent covenants:

> *Except to the extent that the parties to a lease validly agree otherwise* [emphasis added], if the landlord fails to perform a valid promise contained in the lease to do, or to refrain from doing, something…and as a consequence thereof, the tenant is deprived of a significant inducement to the making of the lease, and if the landlord does not perform his promise within a reasonable period of time after being requested to do so, the tenant may (1) terminate the lease. . . . THE RESTATEMENT (SECOND) OF PROPERTY (LANDLORD AND TENANT) §7.1 (1977).

In allowing the tenant to terminate the lease based on the rule of mutually dependent covenants, the SJC specifically distinguished the requirements of a claim of constructive eviction from the requirements of a claim of breach of independent covenants. Proof of constructive eviction requires that the premises be "untenantable for the purposes for which they were used" in order for the tenant to withhold rent or terminate the lease. The tenant may meet the requirements of the mutually dependent covenants rule, however, by demonstrating the landlord's failure, after notice, to perform a promise that was a significant inducement to the tenant's entering into the lease in the first instance. The SJC interpreted this language to include promises that constitute a substantial benefit, understood at the time the lease was entered to be significant