

*Presenting a live 90-minute webinar with interactive Q&A*

## Structuring Tenant Letters of Credit in Commercial Real Estate Transactions

Balancing Interests of Landlord, Landlord's Lender, Tenant, and Issuers of Credit

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THURSDAY, APRIL 10, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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# **STRUCTURING TENANT LETTERS OF** **CREDIT IN COMMERCIAL REAL** **ESTATE TRANSACTIONS**

Presented by:

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# INTRODUCTION

“Good Leases Prevent Bad Problems”

--2 decisions to be made in generally every commercial lease negotiation with respect to Security Deposits:

1) How much? (and the ancillary decisions of whether it is a fixed amount during the lease term, or burns-down)

2) What type?

# AMOUNT OF SECURITY DEPOSIT

The question of how much the Security Deposit should be depends on a number of factors, including, current creditworthiness of tenant entity, landlord's up-front costs that go into the deal (such as free-rent, improvement allowance, brokerage commissions)

--Example of Lehman Brothers

# TYPE OF SECURITY DEPOSIT

Common Types:

- Cash
- Standby Letter of Credit
- Pre-paid Rent
- Surety Bond
- Third Party Guarantee

# THE TWO MOST COMMON TYPES

Is CASH king? Not always.

What is a LETTER OF CREDIT?

- Standby
- Documentary

# ADVANTAGES OF LETTERS OF CREDIT

- Bankruptcy Context: Not part of bankrupt tenant's estate; avoids automatic stay; avoids Section 502(b)(6) cap;
- Obligation of a bank of the landlord's choice
- Landlord can get the money fairly quickly
- Avoids underlying dispute with tenant
- Avoids relying on a third party related to the defaulting tenant
- May not cost the tenant anything!

# DISADVANTAGES OF LETTERS OF CREDIT

- Failure of Issuing Bank
- Administrative
- Additional legal costs involved in reviewing and negotiating form
- May be costly to the tenant

# INTERNATIONAL STANDBY PRACTICES

What is ISP98?

What does it mean for the landlord's letter of credit?

# **STRUCTURING TENANT LETTERS OF CREDIT IN COMMERCIAL REAL ESTATE TRANSACTIONS**

**Presented by:**

**Joyce A. Kuhns, Esq.**

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## **Enforcement of Security Deposits Versus Letters of Credit: Key Bankruptcy Concepts**

- “Property of the Estate”
  - “Property of the estate” is broadly defined to include “all legal or equitable interests of the debtor in property” and proceeds thereof.
  - A bankrupt tenant’s security deposit held by a landlord is “property of the estate.”
- The “Automatic Stay”
  - The Bankruptcy Code imposes an automatic statutory prohibition against any act to obtain possession or control of property of the estate. See 11 U.S.C. § 362(a).

## **Application of Security Deposit**

- A security deposit is typically given to a landlord by a tenant to ensure future performance under a lease.
- An unapplied security deposit becomes property of a debtor's estate.
- Because application of a security deposit is subject to the debtor's rights under the Bankruptcy Code –
  1. The automatic stay protection (see 11 U.S.C. § 362);
  2. The right to provide adequate protection in lieu of a security deposit ( see 11 U.S.C. § 361); and
  3. The right to limit setoff of security deposit against prepetition debt only (see 11 U.S.C. § 553) –
- It is prudent for a landlord to seek court relief before exercising control over a security deposit.

## Draw Down of a Letter of Credit

- Because of the “independence principle,” letter of credit obligations are wholly independent of the contract between the debtor/tenant and the creditor/landlord and generally do not involve any distribution of estate property.
- Courts uniformly hold that neither a letter of credit nor its proceeds are property of the estate. Int’l Fin. Corp. v. Kaiser Group Int’l, Inc. (In re Kaiser Group Int’l, Inc.), 399 F.3d 558 (3d Cir. 2005).
- Therefore the automatic stay does not prohibit a draw down on an uncollateralized letter of credit. See, e.g., Willis v. Celotex Corp., 978 F.2d 146, 148 n.3 (4th Cir. 1991).

## **A High Bar to Preventing a Draw Down of a Letter of Credit**

- Provided that the beneficiary presents the required documents to the issuing bank, the bank must pay under the letter of credit.
- Because letters of credit are not property of the estate, a debtor seeking to restrain distribution of letter of credit proceeds through an injunction faces a difficult hurdle –
  - The public policy behind letters of credit – “pay first, litigate later” – disfavors disruption of prompt payments caused by litigation delay. See In re Sabratek Corp., 257 B.R. 732, 738 (Bankr. D. Del. 2000).
- However, when a letter of credit is collateralized, suits to prevent a debtor from losing its collateral or damages relating to its loss may be viable. See, e.g., Int’l Fin. Corp. v. Kaiser Group Int’l, Inc. (In re Kaiser Group Int’l, Inc.), 399 F.3d 558 (3d Cir. 2005).

## Effect of Security on Landlord Rejection Claim

- Rejection
  - Example: Tenant's monthly rent is \$1,000. Tenant files bankruptcy with 5 years remaining on the lease term. Tenant rejects the lease in the bankruptcy. Therefore, landlord arguably has an actual accelerated damages claim of \$60,000 (\$1,000 multiplied by 60 months remaining term of lease) actual damage claim.
- The 502(b)(6) "Cap"
  - Congress imposed a cap on lease rejection damages to mitigate the dwarfing effect of accelerated lease claims on the unsecured claims pool.
  - Speaking generally, for a lease with a term of less than 80 months (i.e., 6 years, 8 months), a landlord's rejection damages equal a year's worth of rent.
  - Continuing the Example: Landlord's \$60,000 actual damages claim is capped by § 502(b)(6) to \$12,000 (\$1,000 multiplied by 12 months = one year's worth of rent).

## **Application of Security Deposit Versus Letter of Credit to Lease Rejection Damages Claim**

- Continuing example:
  - Assume that the landlord with the \$12,000 capped rejection damage claim held a \$4,000 security deposit or equivalent letter of credit.
    - Should a court apply a security deposit or letter of credit proceeds against the actual accelerated lease loss of \$60,000 or against the capped claim of \$12,000?
- Security Deposit Outcome
  - The prevailing court view favors deducting any cash security intended as a deposit from the 502(b)(6) damage claim.
  - Monies collected from the debtor are typically applied to the 502(b)(6) cap.

## **Application of Security Deposit Versus Letter of Credit to Lease Rejection Damages Claim**

- Letter of Credit Outcome
  - Typically, when a third party issuer provides a letter of credit, the 502(b)(6) cap does not apply. See Musika v. Shopping Ctr. L.P., 257 B.R. 770, 772 (Bankr. D. MD. 2001).
  - However, when a depleted letter of credit must be replenished by cash or a new letter of credit, courts have viewed such letter of credit as cash security and applied the proceeds against the 502(b)(6) cap. See In re PPI Enterprises (U.S.), Inc., 324 F.3d 197 (3d Cir. 2003).

## **Practical Takeaways on Bankruptcy Issues**

1. A cash deposit is subject to the automatic stay. The landlord should take no action vis-à-vis the cash deposit without court approval.
2. A letter of credit (and its proceeds) is not property of the estate subject to the automatic stay, unless it is secured by the tenant's collateral.
3. The landlord may not want to file a claim if (a) a landlord's rejection damages claim will likely be reduced by a cash deposit deemed a cash security (whether called a security deposit or a cash-collateralized letter of credit) or (b) if the landlord's letter of credit exceeds the capped rejection damage claim.

# **WHAT CAN YOU LEARN FROM A WELL-CRAFTED LETTER OF CREDIT?**

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# What Can You Learn From A Well-Crafted Letter Of Credit?

- Who are the players?
- What is the maximum benefit?
- Does it have an expiration date?
- Is it evergreen?
- Does it permit only one draw or multiple draws?
- What does beneficiary have to do in order to draw?
- Can it be transferred? If so, who pays the costs?
- How and where must presentation occur?

# Drafting Tips

- Lease requirements and form of letter of credit should dovetail
- Always attach required form of letter of credit to lease
- Lease language should allow landlord to perform due diligence as to issuer of letter of credit
- Preferable to have key elements of letter of credit arrangement in lease as well
- Address mechanics and logistics of any mandatory reductions or assignments

# **More Exotic Issues**

- **Why prefer cash to letters of credit as a security deposit?**
- **Assignment of lease and effect on letter of credit**
- **How to handle mandatory reductions in security deposits**
- **Keep that authorization simple**
- **How to make evergreen functional**
- **Split security deposits – cash and letters of credit**

# **Hallmarks of a Well-Crafted Letter of Credit**

- Accurately reflects the intentions and agreements of the parties
- Clarity of instruction
- Brevity

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