Draw on Letter of Credit Not Limited by Cap on Landlord Claims

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Nicholas M. Miller and Joshua P. Weisser

Parties to commercial transactions routinely employ letters of credit as a means of minimizing credit exposure and shifting the risk of non-performance. As a general rule, even a bankruptcy filing by the account debtor will not prevent the beneficiary from drawing on a letter of credit because the letter of credit is not deemed property of the debtor's bankruptcy estate, and the obligation of the issuing bank to honor the letter of credit is wholly independent of the account debtor's obligation to pay the underlying debt. This "independence principle" is crucial to the efficient operation of the credit markets and the cornerstone of letter-of-credit law.

Letters of credit have become an increasingly common feature of commercial leases as an alternative to traditional security deposits. In this context, the general rule permitting unfettered access to the proceeds of a letter of credit notwithstanding a bankruptcy filing by the obligor may conflict with certain limitations contained in the Bankruptcy Code on the maximum claim allowed to a landlord for damages resulting from breach of a lease. This apparent conflict was addressed in a ruling recently handed down by the Fifth Circuit Court of Appeals. In *In re Stonebridge Technologies, Inc.*, the Court of Appeals held that a landlord could draw down on a letter of credit even though the amount in question exceeded the statutory cap on landlord claims because the landlord never filed a proof of claim in the lessee's bankruptcy case.

Letters of Credit and the Independence Principle

The ordinary letter-of-credit scenario involves three distinct obligations: (i) the account debtor's obligation to make payment or perform under a contract or lease; (ii) the issuing bank's obligation to pay on the letter of credit when presented by the beneficiary; and (iii) the account debtor's obligation to reimburse the issuer. As a general rule, the issuer's obligation to pay the beneficiary when presented with a demand that conforms with the specifications stated in the letter of credit is completely independent of any obligations arising under the contract between the account debtor and the beneficiary. This rule is sometimes referred to as the "independence principle." As applied, it means that neither the letter of credit nor its proceeds belong to the account debtor, and neither constitutes property of the debtor's estate if it later files for bankruptcy.

It has become increasingly common for landlords to obtain security deposits in the form of letters of credit. The latter offer certain advantages over traditional security deposits. Among these are the landlord's ability to draw on the proceeds as a remedy for breach even if the lessee files for bankruptcy protection. On the flip side, letter-of-credit transactions are more complex than traditional security deposits, and more actions are required after delivery to recover funds under a letter of credit.

Real Property Lease Claims in Bankruptcy

Notwithstanding the independence principle, a bankruptcy filing by the lessee could prevent a landlord from taking full advantage of security given under a lease in the form of a letter of credit. This is so because the Bankruptcy Code caps the maximum claim allowed to a landlord arising from the termination of a lease. Under section 502(b)(6), claims resulting from termination of a lease are limited to the rent reserved by the lease, without acceleration, for the

greater of either (i) one year or (ii) 15 percent of the remaining lease term (not to exceed three years). The remaining lease term is measured by the earlier of the petition date or the date on which the landlord repossessed or the debtor surrendered the property. The cap is intended to compensate the landlord for the loss associated with the termination of the lease while at the same time preventing the lease-termination claim from overwhelming the pool of general unsecured claims.

In the case of a secured landlord, most courts hold that the deposit or other security must be applied towards the capped claim, and that any excess must be returned to the bankruptcy estate. This approach, however, would appear to be fundamentally at odds with the independence principle, which removes the proceeds in their entirety from the reach of the lessee's bankruptcy estate. This incongruity was the subject of the Fifth Circuit's ruling in *Stonebridge Technologies*.

Stonebridge Technologies

Stonebridge Technologies, Inc. and EOP-Colonnade of Dallas Limited Partnership (the "landlord") entered into a lease agreement for certain office space in 2001. Stonebridge's obligations under the lease were secured by a $1.4 million irrevocable standby letter of credit issued by the Bank of Oklahoma. As partial security for its potential obligation to reimburse the bank in the event of a draw on the letter of credit, Stonebridge executed a secured note in the amount of $1.25 million.

Stonebridge owed the landlord back rent and other miscellaneous charges under the lease when it filed for bankruptcy in 2001. When it failed to pay post-petition rent, the landlord sought an

order from the bankruptcy court compelling payment of all amounts outstanding. Stonebridge and the landlord ultimately reached a settlement whereby Stonebridge would reject the existing lease and enter into a new short-term lease for the premises. The bankruptcy court order authorizing rejection of the lease fixed the landlord's claims for unpaid pre- and post-petition rent but did not address the issue of rejection damages. The landlord never filed a proof of claim for amounts due under the lease.

Shortly before the court authorized rejection of the lease, the landlord initiated a draw request for the full amount of the letter of credit. The undisputed amount of the landlord's rejection damages at the time was between $1.5 and $1.6 million, based on the acceleration formula under the lease. The rejection damage cap in section 502(b)(6) would have limited the landlord's damages to approximately $1.35 million. The bank honored the letter of credit and disbursed $1.4 million to the landlord.

Stonebridge confirmed a liquidating chapter 11 plan. The liquidating trustee sued the landlord, claiming, among other things, that the landlord had prematurely drawn on the letter of credit and that any proceeds exceeding the section 502(b)(6) cap should be returned to Stonebridge's estate. The bankruptcy court's ruling in favor of the trustee was affirmed on appeal by the district court.

The Fifth Circuit Court of Appeals reversed. It ruled that the landlord did not draw on the letter of credit prematurely because, in accordance with the independence principle, the letter of credit was not estate property. The terms of the letter of credit, the Fifth Circuit explained, permitted the landlord to make a demand if, among other things, there was a "monetary default" that

remained uncured for at least five days after delivery of a notice of default to the debtor. These conditions were fulfilled. In addition, the Court of Appeals noted, a provision in the letter of credit authorizing the landlord to draw down the proceeds in the event of Stonebridge's insolvency — an unenforceable "*ipso facto*" clause under section 365(e)(1) of the Bankruptcy Code if applied to trigger forfeiture of a debtor's rights — was valid in this case because it did not involve Stonebridge or property of its bankruptcy estate.

Regarding the section 502(b)(6) cap, the Fifth Circuit held that a "claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all." Because the landlord had not filed a proof of claim in Stonebridge's chapter 11 case, the Court of Appeals explained, other decisions requiring landlords to remit security applied in excess of the statutory limitation were distinguishable. To hold otherwise, the Fifth Circuit observed, would convert section 502(b)(6) "into a self-effectuating avoiding power that would allow the trustee to bring an adversary proceeding against a lessor who exercises his rights under a letter of credit." According to the Court of Appeals, this would be a clear departure from the plain language of section 502(b)(6), which "allows only one thing — disallowance of the filed claim to the extent that it exceeds the statutory cap."

Outlook

Stonebridge Technologies highlights the need for landlords to carefully evaluate their claims and the extent of their security before filing a proof of claim. In *Stonebridge Technologies*, had the landlord filed a proof of claim, its claim for damages arising from rejection of the lease (principally future rent) would have been subject to the statutory cap, and it would have been

compelled to return nearly $100,000 in proceeds from the letter of credit to the bankruptcy estate. With different facts, the forfeited security could have been even greater.

Most courts hold that section 502(b)(6) limits a landlord's claim even if the debtor posted a security deposit in an amount exceeding the cap. Some courts, including the Third Circuit Court of Appeals, have applied the same reasoning to limit lease rejection claims where the security posted was a letter of credit. In *Stonebridge Technologies*, the Fifth Circuit suggests that these cases are distinguishable because the landlords filed proof of their claims. Given the purpose of section 502(b)(6) and the increasing reliance of commercial lessors on letters of credit as an alternative to traditional security deposits, the distinction may be one of form over substance.

In re Stonebridge Technologies, Inc., 430 F.3d 260 (5th Cir. 2005).

Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.), 324 F.3d 197 (3d Cir. 2003).

Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.), 306 B.R. 295 (Bankr. 9th Cir. 2004).