

## **Exploring the Boundaries of the “Independence Principle”**

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Much has been written recently about the impact of a bankruptcy filing on the right of a nondebtor landlord to draw on a letter of credit posted as security for the tenant’s obligations under a lease of nonresidential real property. The focus of recent court rulings and commentary, however, has generally been directed to various restrictions, such as the statutory cap placed on damage claims under commercial leases, on the lessor’s ability to apply the full amount of the proceeds of a letter of credit to the lessee’s obligations, notwithstanding the common-law “independence principle” that, as a general rule, operates to make a lessor’s remedies under a letter of credit inviolate in the event of a bankruptcy filing by the lessee.

A recent decision by the Eleventh Circuit Court of Appeals illustrates another potential hazard for lessors who believe their rights under a real property lease are fully secured by a letter of credit. In *In re Builders Transport, Inc.*, the court of appeals held that a standby letter of credit beneficiary was required under section 542 of the Bankruptcy Code to turn over proceeds of a letter of credit improperly retained after the commencement of a bankruptcy case by the lessee.

### **Drawdown and Distribution of Letter of Credit Proceeds**

A typical letter of credit transaction securing a lease involves three independent sets of obligations: (a) the lessee’s obligations to perform under the terms of the lease; (b) the letter of credit issuer’s obligation to pay the amount of any draw under the letter of credit when presented by the lessor beneficiary; and (c) the lessee’s obligation to reimburse the letter of credit issuer for

the amounts drawn on the letter of credit. Under what is commonly referred to as the “independence principle,” the obligation of the issuer to pay the beneficiary upon presentment of the letter of credit is independent from the lessee’s obligations under the lease. As a result, the letter of credit is not property of the debtor’s bankruptcy estate and, as a general rule, the automatic stay does not prevent the beneficiary from presenting and drawing on the letter of credit after the lessee files for bankruptcy. Once the letter of credit is drawn, however, distribution of the cash proceeds is subject to the terms of the lease that the letter of credit secures. The Court of Appeals for the Eleventh Circuit addressed certain complications that arise once a letter of credit is drawn during the course of a chapter 11 case in *Builders Transport*.

### ***Builders Transport***

Prior to filing for chapter 11 protection in 1998, South Carolina-based trucking concern Builders Transport, Inc. (“BTI”) entered into a sale-leaseback transaction with an unrelated entity (“Two Trees”) to realize a capital-loss carryforward that could be used if and when BTI later generated income to offset the loss. Under the terms of the transaction, BTI sold its headquarters facility to Two Trees for \$3.5 million and leased the facility back from Two Trees. The lease agreement provided for a 60-month term with an option for BTI to renew for four additional 60-month terms. The lease also required BTI to obtain a letter of credit in the amount of \$1.6 million in favor of Two Trees to secure BTI’s lease obligations.

Two Trees entered into a separate loan agreement pursuant to which it borrowed the \$3.5 million used to purchase the headquarters facility from BTI. The amount of BTI’s monthly lease payment under the terms of the lease between BTI and Two Trees equaled the amount required to service the monthly debt, and BTI’s lease payments went directly to Two Trees’ lender

pursuant to the terms of the loan documents. However, the lease payments due under the initial term of the lease did not fully amortize Two Trees' mortgage — had BTI fulfilled its rent obligations under the initial 60-month term, Two Trees still would have owed its lender more than \$2 million.

Prior to the expiration of the initial 60-month lease term, BTI and its parent filed for chapter 11 protection in Georgia. When it soon became evident that the debtors had no prospects for reorganizing, BTI obtained court approval to sell certain assets to Schneider National, Inc. ("Schneider"). Pursuant to their asset purchase agreement, BTI and Schneider agreed that they would jointly occupy the headquarters property and share in the obligation to make rent payments under the terms of the lease with Two Trees.

Shortly after consummation of the sale and occupation of the headquarters facility by Schneider, BTI's lender sent a default and acceleration notice to the letter of credit issuer, notifying it that BTI's obligations under the lease agreement were immediately due. In response to the default notice, the issuer notified Two Trees' lender that the letter of credit would expire in 30 days because the lease obligations of BTI had been accelerated. Before the letter of credit expired, Two Trees' lender drew down the entire amount of the \$1.6 million letter of credit. The lender then applied the proceeds against Two Trees' debt incurred in connection with the purchase of the headquarters facility. BTI's lender reimbursed the letter of credit issuer for the full amount of the \$1.6 million draw on the letter of credit. Less than six months after the sale to Schneider, both BTI and Schneider had vacated the headquarters facility, and Two Trees sold the facility to

a third party shortly thereafter. Neither Two Trees nor its lender filed a proof of claim in BTI's chapter 11 case.

One month later, BTI commenced litigation against Two Trees, its lender and certain principals of Two Trees, alleging that the \$1.6 million proceeds of the letter of credit were property of BTI's chapter 11 estate to the extent the proceeds exceeded the amount of Two Trees' allowed claim for lease rejection damages under applicable nonbankruptcy law. The bankruptcy court ruled that the excess letter of credit proceeds were property of BTI's estate. In a subsequent order, it directed the defendants to pay damages to BTI in the amount of approximately \$1.2 million, finding that Two Trees' allowed claim for lease-rejection damages amounted to approximately \$400,000 under South Carolina law. Because the damage claim did not exceed the statutory cap set forth in section 502(b)(6) of the Bankruptcy Code (the greater of one year's rent, or 15 percent, not to exceed three years, of the rent reserved for the remaining term), the court did not apply the cap to limit the landlord's allowed lease-rejection claim. The district court affirmed those rulings on appeal, and the defendants appealed to the Eleventh Circuit.

### **The Eleventh Circuit's Ruling**

On appeal to the Eleventh Circuit, the defendants argued that, under the doctrine of independence, the proceeds of the letter of credit were not property of the estate subject to turnover under section 542 of the Bankruptcy Code. The court of appeals rejected this contention, drawing a distinction between the initial draw on a letter of credit, which is protected under the doctrine of independence, and the right to the proceeds of the drawn letter of credit, which is not. "[O]nce the proceeds of a letter of credit have been drawn down," the Eleventh Circuit explained, "the underlying contracts become pertinent in determining which parties have

a right to those proceeds.” According to the court, BTI’s turnover action challenged the application of the letter of credit proceeds under the terms of the lease agreement, not the propriety of the initial draw on the letter of credit. As a result, the court of appeals ruled, the doctrine of independence is not applicable.

The Eleventh Circuit then examined the provisions of the lease agreement to determine what obligations were secured by the letter of credit. In addition to rent, the defendants argued, the lease provided that BTI was obligated to secure Two Trees’ mortgage obligation to its lender. The court of appeals rejected this argument, finding that neither the unambiguous terms of the lease nor any other evidence supported the claim that the letter of credit secured anything more than BTI’s lease obligations. Accordingly, the Eleventh Circuit ruled, the letter of credit secured only the landlord’s claim against BTI (approximately \$400,000), and any excess proceeds of the letter of credit were property of BTI’s estate subject to turnover under section 542.

The court of appeals rejected the argument that the full \$1.6 million letter of credit proceeds were “special” damages arising from BTI’s breach of the lease, to which, according to the terms of the agreement, they were entitled to recover, up to the amount of Two Trees’ outstanding mortgage debt. The Eleventh Circuit characterized as “unsustainable” the defendants’ claims that the entire arrangement was intended to be a secured-financing transaction, rather than a lease, such that the letter of credit also acted as security for Two Trees’ mortgage obligations.

Finally, the Eleventh Circuit harmonized its ruling with the 2005 decision handed down by the Fifth Circuit Court of Appeals in *In re Stonebridge Technologies Inc.*, where the court ruled that

the filing of a proof of claim by the lessor against the estate is a precondition to applying the damages cap under section 502(b)(6). In the case before it, the Eleventh Circuit noted, the statutory cap was never at issue because the landlord's actual damage claim calculated according to applicable nonbankruptcy law did not exceed the limitation. The turnover litigation commenced by BTI, the court emphasized, "was not predicated on the fact that its lessor's assignee retained funds in excess of the § 502(b)(6) damages cap, but rather on the fact that its lessor's assignee was not entitled to retain the funds pursuant to the underlying lease agreement."

### **Analysis**

The Eleventh Circuit's decision in *Builders Transport* is not groundbreaking. The ruling recognizes, as most courts have, that the independence principle protects a letter of credit beneficiary's right to draw on a letter of credit, even in the event of a bankruptcy filing by the account debtor. Also, the decision recognizes, as most courts have, that a letter of credit beneficiary is entitled to the proceeds of a letter of credit only up to the amount of the damages secured by the letter of credit. Interestingly, the court of appeals was able to sidestep one of the most potentially sticky legal issues posed by the scenario before it — the Eleventh Circuit did not have to decide whether section 502(b)(6) limits the claim of a landlord who draws on a letter of credit, but never becomes directly involved in the lessee's bankruptcy case by filing a proof of claim.

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*In re Builders Transport Inc.*, 471 F.3d 1178 (11<sup>th</sup> Cir. 2006).

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