

LETTERS OF CREDIT: HOW SAFE IS YOUR SECURITY?

In recent years, it has become increasingly more common for commercial landlords, sellers of real estate, and even lenders to obtain security from tenants, buyers, and borrowers in the form of a letter of credit, as opposed to cash. Letters of credit became the preferred form of security following an increasing wave of bankruptcies during the last couple of decades because in most cases, when properly structured and drafted, neither a letter of credit nor its proceeds become the property of an entity's estate upon bankruptcy. In the climate of today's financial crises and the instability and failure of banks throughout the country, we are now facing a new and equally critical issue: the stability of every letter of credit is dependent upon the stability of the bank that issued it. If you are the beneficiary under an irrevocable standby letter of credit and the issuing bank fails, what happens to your letter of credit? Do you have the security you bargained for?

A letter of credit is a contractual obligation of the issuing bank to pay the recipient of the letter of credit (a beneficiary) upon the happening of circumstances specified in the letter of credit. The applicant (the tenant, buyer, or borrower) enters into certain loan agreements with the issuing bank, promising to reimburse the bank if the beneficiary draws upon the letter of credit. Depending upon the financial strength of the applicant and the relationship between the applicant and the issuing bank, the issuing bank may agree to issue the letter of credit on an unsecured basis or it may require the applicant to provide cash or other collateral to secure the applicant's reimbursement obligations.

If the issuing bank fails, the Federal Deposit Insurance Corporation (FDIC) or another regulatory agency will typically place such bank into a receivership. In the past, upon becoming the receiver for a failed bank the FDIC reserved the right to repudiate letters of credit and it may elect to do the same in the current crisis. A letter of credit is typically not considered an insured deposit.

Given the risks concerning the financial stability of issuing banks today, the beneficiary should perform due diligence on the proposed issuing bank before it accepts a letter of credit. The beneficiary should confirm, for instance, that the bank has its long- and short-term debt highly rated by the various nationally recognized security rating agencies (such as Standard & Poor's, Moody's, or Fitch Ratings) and that it has sufficient capital. Unfortunately, the FDIC will not publicize the banks it is watching, which are potentially undercapitalized, but we do know that the financial

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Market Volatility and the Changing Regulatory Landscape

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services sector is continuing to forecast the possibility that a large number of banks, possibly hundreds, may go into receivership in 2009.

Once the letter of credit is issued, the beneficiary should continue to monitor the financial strength of the bank. The beneficiary should also provide additional protection by including provisions into the lease, sales, or loan document granting it the right to require the letter of credit to be replaced by a letter of credit from another bank in certain circumstances. Minimally, if the bank goes into a receivership or a conservatorship then the letter of credit should be replaced. An earlier trigger for replacement should be activated by the drop in the issuing bank's credit ratings below a specified level by the national security rating agencies. Some banks, such as most of the regional banks, are too small to have their debt rated by these agencies. Another method needs to be created to determine the ongoing financial health of those banks, such as the Safe & Sound® ratings at www.bankrate.com. If the stated financial criteria are not met, the beneficiary should exercise its right to require a replacement letter of credit and if the letter of credit is not replaced within a set time period, then the lease, sales, or loan document should allow the beneficiary to draw on the letter of credit it is holding.

Arnold & Porter recommends that beneficiaries enforce their rights if the issuing bank's ratings fall below the specified levels. Beneficiaries should check the status of a proposed issuing bank before they accept a letter of credit and be vigilant in monitoring the financial health of all issuing banks on a regular basis, in order to avoid ending up with a worthless piece of paper as security.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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