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The Legal Corner

Letters of Credit as Tenant Security Deposits: Bankruptcy Pitfalls to Avoid

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Landlords often seek security from tenants in the form of a letter of credit, or "LC." LCs, which are typically issued by a third party bank, often allow landlords to draw on the proceeds should the tenant fail to pay rent. Should a tenant file for bankruptcy protection, however, landlords may find themselves with fewer rights than they bargained for. Recent bankruptcy court decisions, further, have exposed several pitfalls of which landlords need to be aware of to protect their rights.

The beneficiaries of LCs enjoy a kind of protection under the common law deriving from the so-called "Independence Principal."

The Independence Principal states that courts treat as independent each of the three sets of transactions among the borrower, issuer, and beneficiary. In a bankruptcy context, this means that the automatic stay imposed when a tenant files for bankruptcy protection generally does not extend to the draw-down of an LC posted by the issuing bank: provided that all pre-conditions are met, the landlord is free to draw on the proceeds of the LC regardless of the tenant's opinion on the matter.

Once the proceeds of the LC are in the hands of a landlord, however, a bankruptcy court may require the landlord to return a portion (or all) of the proceeds to the debtor's estate. The first hurdle a landlord must overcome is whether, pursuant to the terms of the lease, the tenant retains some interest in proceeds even after a draw-down from an LC. If the answer is yes, then the estate may seek a turnover order bringing the proceeds back into the estate. Cautious landlords should insist on lease language which strips a tenant of all interest in proceeds drawn down from an LC, including any reversionary or contingent interest.

Similarly, a landlord may have to defend itself against the assertion that, rather than violating the automatic stay, its draw on the proceeds was contractually improper. Provided that all pre-conditions to a draw have been met, this should not prove problematic for the landlord. However, if a draw is conditioned on the landlord providing notice to the tenant of its default, the debtor might assert this to be an action meant to exercise control over the estate, a technical violation of the automatic stay which may prevent the landlord from satisfying this condition. Careful drafting solves this problem -- landlords should insist that the LC agreement allows a draw on the LC proceeds, after notice to the issuing entity, after a certain number of days' failure by the tenant to pay rent, with no other requirement. Landlords should also be sure to include an acceleration clause which will permit a draw equal to the entire remaining amount due under the lease, not just enough to cover the current amount of tenant's unpaid rent.

Bankruptcy law impacts landlord recoveries against tenants in an additional significant way: if a debtor/tenant terminates a lease, a landlord's claim for damages is capped at one to three-year's unpaid rent, depending on the amount of time remaining on the lease, plus all rent owing as of the petition date. Further, if the tenant already has provided the landlord with a security deposit, the amount of that deposit counts against the landlord's capped claim. If the security deposit is equal to or less than the landlord's capped claim, the landlord is entitled to recover only the balance from the estate. If the amount of the security deposit is higher than the cap, the landlord is required to return the excess to the estate, and the landlord's claim is treated as if it were paid in full.

Courts are less uniform on the relationship of LC proceeds to security deposits. Some courts treat these proceeds as security deposits as a matter of law, and have ruled that LC proceeds will always count toward a landlord's capped claim. Other courts seem to treat the issue as one of fact, and base their determination on the particular language of the lease. It is still an open issue in many courts whether LC proceeds will count against a landlord's capped claim if (1) the lease is silent as to the existence of a security deposit, and (2) the lease allows the landlord to draw on an LC should the tenant fail to pay rent. Landlords might attempt to draft around this problem by being careful to not describe the LC as a "security deposit" or "in lieu of a security deposit" in the

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lease, but it is unclear if this tactic will work given what seems to be a trend in favor of treating LC proceeds as security deposits -- and applying them towards the landlord's capped claim -- regardless of how the lease is drafted.

Another bankruptcy trap exists for landlords. At least one recent bankruptcy decision has held that a landlord is not required to return LC proceeds in excess of the landlord's capped claim if that landlord has not filed a proof of claim. Because the "landlord cap" is described in the Bankruptcy Code as a limitation on a landlord's claim rather than as a unique avoidance power of the debtor's estate, this court held that the debtor had no power to force the landlord to disgorge the excess LC proceeds. Thus, landlords who have drawn on proceeds from an LC in an amount in excess of their capped claim may actually harm themselves by filing a proof of claim in a tenant's bankruptcy case: they may be forced to turn over a portion of their LC proceeds they might otherwise have been able to keep.

Accordingly, landlords should carefully consider their options when a tenant files for bankruptcy protection. If a landlord has the option of drawing on the proceeds of an LC, it should do so without fear of violating the automatic stay. If it obtains proceeds is in excess of the amount of its capped claim, the landlord should carefully consider its options before filing a proof of claim. In certain situations, a landlord may have nothing to lose and a lot to gain by simply walking away from the tenant's bankruptcy case.

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