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Legal Alert

Will Your Letters of Credit Be Honored? The FDIC Warns It Will Not Honor Letters of Credit Issued by Banks In Receivership

In the early 1990s, many commercial landlords experienced a significant increase in the number of defaults by their office and retail tenants. This situation prompted many

landlords to require credit enhancement in connection with leases to noncredit tenants. Because of tenant bankruptcy concerns, the preferred source of credit enhancement became letters of credit. As the late 1990s and early part of this decade brought an influx of dot-com companies with no financial track records, commercial landlords were forced to rely heavily on letters of credit for security against tenant defaults and bankruptcies. Given the current market conditions and the ongoing rise in office and retail tenant defaults, commercial landlords are again relying heavily on credit enhancement instruments as a source of financial security. Accordingly, the use of letters of credit as the preferred credit enhancement instrument is more in focus now than ever before.

With the recent bank failures and FDIC take-overs, however, an unprecedented threat against the viability of bank-issued letters of credit has emerged. The FDIC has warned that it will not honor letters of credit issued by banks which have been placed in receivership. This potential refusal by the FDIC to honor letters of credit issued by banks in receivership may cause the virtual disappearance of numerous bank-issued letters of credit and the credit enhancement those letters of credit provide to landlords.

As the FDIC's list of failed banks continues to grow, large numbers of landlords will find themselves in possession of letters of credit that may not be honored when needed, which is a significant risk given the nation's current economic downturn. Unless specific preemptive actions are taken by a landlord, a landlord may be left without the credit enhancement it bargained for (as few commercial leases provide an express remedy for landlords if a bank fails to honor a letter of credit).

The following is meant to provide helpful approaches that landlords may use to safeguard existing letters of credit and when negotiating requirements with respect to future letters of credit.

This alert applies to new issues facing landlords. It addresses ways of safeguarding existing letters of credit when issuing banks are placed in receivership.

About Allen Matkins

Allen Matkins Leck Gamble Mallory & Natsis LLP is a California law firm with over 230 attorneys practicing out of seven offices in Century City, Los Angeles, Orange County, Del Mar Heights, San Diego, San Francisco and Walnut Creek. The firm's broad based areas of focus include real estate, real estate finance, bankruptcy and creditors' rights, employment and labor law, corporate, construction, business litigation, taxation, land use, intellectual property and environmental. [more...](#)

I. APPROACHES TO EXISTING LETTERS OF CREDIT. _In

connection with letters of credit from existing tenants, the following are a few preemptive actions landlords can take to safeguard such credit enhancement instruments.

- **Monitor Issuing Bank's Financial Rating.** It is important for a landlord to establish an internal function to continuously monitor the financial ratings of the banks that have issued the letters of credit that such landlord currently holds. Private companies regularly publish rating information for various banks. Through the FDIC's website, landlords can also view copies of the "Report of Condition and Income" (referred to as a "Call Report") of the individual banks. In addition, the FDIC's "[Failed Bank List](#)" should be monitored closely to identify those issuing banks that may be in receivership.
- **Attempt to Modify Existing Letter of Credit Provisions.** To the extent a tenant is approaching a landlord regarding a short-term lease renewal, a rental abatement/reduction agreement or a possible lease work-out or restructuring, a landlord should use its interactions with such tenant as a key opportunity to negotiate necessary modifications and updates to the existing letter of credit provision contained in tenant's underlying lease (which specific modifications and updates are discussed further in Section II below). Additionally, any time the parties intend to execute a lease amendment or side letter, landlord should encourage the incorporation of necessary letter of credit updates into the applicable amendment or side letter.
- **Approach Tenants Whose Banks are Failing.** Landlords are not the only party at risk in connection with bank failures and FDIC take-overs. Many tenants are required to post cash collateral with the issuing banks before the letters of credit can be issued in favor of the named beneficiaries (e.g., landlords). A tenant's cash deposit may be at risk if the bank is placed in receivership and the FDIC fails to honor the letter of credit issued by such bank, and simultaneously, the bank fails to recognize or honor the corresponding cash collateral deposit posted by the tenant. Therefore, it will be mutually beneficial, in many cases, for a landlord to approach a tenant whose bank is failing and recommend that the parties work together to find an alternative bank to issue the required letter of credit.
- **Additional Landlord Remedies.** If the foregoing approaches do not work in connection with a letter of credit that is at risk, Allen Matkins has additional recommendations (which can only be disclosed in privileged discussions with clients) regarding the actions landlords may take to protect themselves against the effects of impending bank failures.

II. APPROACHES TO NEW LETTERS OF CREDIT. _With

respect to new letters of credit, landlords should seek to implement the following key conditions regarding letter of credit instruments that are to be provided by tenants.

- **Landlord Approval Rights Over Issuing Bank.** For small to mid-sized lease transactions, landlords should have reasonable approval rights over the banks issuing the required letters of credit (which approval may be conditioned upon the issuing banks' ability to meet a minimum financial rating threshold). For lease transactions that are to be secured by large letters of credit, landlords should require that the bank issuing such letters of credit be one of a handful of banks pre-approved by landlord, which list should only include the world's leading and most solvent banks.
- **Continuous Monitoring of Issuing Bank's Financial Rating.** All new leases that require a letter of credit from the tenant should include a mechanism that allows a landlord to continuously monitor the issuing bank's financial rating throughout the applicable lease term. If, at any time during the applicable lease term, (a) the issuing bank's financial rating falls below the rating threshold established under the lease, or (b) the issuing bank is no longer considered to be well capitalized under the prompt corrective action rules of the FDIC (as disclosed by such bank's Call Report) or is placed into receivership by the FDIC, the tenant should be required (within a limited number of business days) to deliver a replacement letter of credit from another bank whose financial rating meets or exceeds the required threshold.
- **Landlord Remedy for Tenant's Failure to Post Replacement Letter of Credit.** In the event the issuing bank's financial rating decreases below the established rating threshold, or the issuing bank is no longer considered well capitalized or is placed into receivership, and the tenant fails to timely provide the landlord with a replacement letter of credit (from another bank in good standing whose financial rating meets or exceeds the minimum threshold), such failure should be deemed a tenant default under the lease for which landlord may: (1) immediately draw upon the full amount of the existing letter of credit, and/or (2) increase tenant's then current rent obligations under the lease until a qualified replacement letter of credit is delivered to landlord.

Obviously, the foregoing is only a brief overview of the risks that landlords now face in connection with the honoring of letters of credit and the remedies that a landlord may implement. Please contact the undersigned if you desire to discuss the foregoing further or to discuss any other issues relating to the structuring and enforcement of credit enhancement instruments.

Best regards,

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