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Recent Developments In The Bankruptcy Treatment Of Letters Of Credit Under Commercial Real Estate Leases

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When faced with a bankrupt tenant who furnished a letter of credit to secure the obligations due under its lease, the landlord should carefully consider whether or not to file a proof of claim in the tenant's bankruptcy case.

RECENT BANKRUPTCY decisions highlight important concerns regarding the rights of commercial landlords under letters of credit ("L/Cs") furnished to assure the payment of tenant obligations. These developments in the law warrant consideration in the structuring and documentation of leases and L/Cs provided by tenants for benefit of landlords. Notwithstanding traditional concepts of the independence of L/Cs, landlords should not assume that L/Cs or proceeds drawn under them will be immune from bankruptcy court scrutiny.

L/C BASICS • L/Cs have become common devices to assure the performance and payment of tenants' obligations under commercial real estate leases. The "independence principle" is the critical element that makes the L/C the device of choice for landlords and other creditors. The L/C represents an obligation of the issuing bank to pay the beneficiary. Upon fulfillment of the conditions for a draw on the L/C, the bank's obligation to the beneficiary is absolute and independent of any obligation between the beneficiary and the bank's customer. The bank customer who purchased the L/C for the beneficiary, as the account party with the bank, in turn is independently obligated to reimburse the bank for the payment of the L/C.

L/C Not Part Of Bankruptcy Estate

In the bankruptcy context, an L/C issued in favor of a creditor is especially advantageous to provide security for the debtor's obligation. The issuing bank's obligation to pay under the L/C (subject to satisfaction of the conditions for a draw) is independent of the relationship between the debtor and its bank. As such, under established bankruptcy jurisprudence, the L/C and its proceeds are not property of the bankruptcy estate. Accordingly, upon fulfillment of the conditions for presentment and honor of the L/C, the creditor may collect the proceeds from the issuing bank without having to seek prior relief from the automatic stay that arises upon the commencement of a bankruptcy case. E.g., *Willis v. Celotex Corp.*, 978 F.2d 146 (4th Cir. 1992), *cert. denied,* 507 U.S. 1030 (1993); *In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987). Some scenarios:

- If the issuing bank pays under the L/C, the bank must then look to its customer for reimbursement of the payments under the L/C;
- If it holds collateral to secure the reimbursement obligation, the bank may pursue its remedies against the collateral;
- If the customer is a debtor in a bankruptcy case, the bank must first obtain relief from the bankruptcy court from the automatic stay before proceeding against the collateral;
- If the customer's reimbursement obligation is unsecured, the bank will have the status of a general creditor and must file a proof of claim to recover on its claim in the bankruptcy case. In that situation, the bank runs the risk—as do unsecured creditors generally—of realizing only a partial recovery if the bankruptcy estate's assets are insufficient to pay creditors in full.

Whatever the context, a landlord who receives payment under an L/C posted by a tenant to assure performance of a lease should be able to hold the funds and apply them, seemingly unfettered, in satisfaction of the tenant's obligations under the lease. Nevertheless, recent cases call for considerable caution in a landlord's decision to draw on an L/C during a tenant's bankruptcy case. In particular, the landlord, as creditor, must carefully consider whether to submit a formal claim in the debtor-tenant's bankruptcy case, especially if the L/C proceeds exceed the amount of the claim that the landlord could assert in the bankruptcy case for "rejection damages."

TREATMENT OF UNEXPIRED LEASES IN BANKRUPTCY • Under section 365 of the Bankruptcy Code, an unexpired lease may be "assumed" or "rejected" by the debtor in the reasonable exercise of its business judgment, subject to the approval of the bankruptcy court. 11 U.S.C. §365.

Assumed Leases

If it is assumed, the lease remains in force in all respects, all pre-assumption defaults must be cured, and the obligations of the lease remain subject to performance in accordance with their terms. The debtor or bankruptcy trustee may be able to assign an unexpired lease to a third party even when the lease contains an anti-assignment clause. When the debtor or bankruptcy trustee seeks to assign an unexpired lease to a third party, the Bankruptcy Code generally invalidates (solely for purposes of the assignment sought in the bankruptcy case) any anti-assignment clauses and other provisions of an unexpired lease that expressly restrict or that operate to frustrate the assignment of unexpired leases. 11 U.S.C. §365(f)(1). The key exception to this rule involves shopping center leases, for which the statute specifically recognizes the enforceability of provisions that restrict, for example, use, operating location, tenant mix, and anchor leasing rights. 11 U.S.C. §365(b)(3).

Rejected Leases

In contrast, rejection of an unexpired lease is treated as the equivalent of a material breach of the

lease as of the day immediately preceding the commencement of the bankruptcy case. This permits the landlord to suspend any further performance or obligation to the debtor and to assert an unsecured claim for damages caused by the breach.

Landlord's Claim And The Statutory Cap On Landlord's Damages

Under the Bankruptcy Code, a landlord may assert a claim for damages arising from termination or rejection of a real property lease. The landlord's claim may include unpaid pre-petition rent as well as rent reserved for the remainder of the term, but will be subject to a statutory cap for the prospective loss. In particular, section 502(b)(6) of the Bankruptcy Code limits the landlord's claim for prospective rent reserved by the lease to the greater of one year, or 15 percent, not to exceed three years, of the remaining term (without acceleration) following the earlier of the commencement of the bankruptcy case or the date on which the leased premises were surrendered by the tenant or repossessed by the landlord. 11 U.S.C. §502(b)(6)(A). Most courts apply the "15 percent" measure to the total amount of rent due during the remainder of the lease. *E.g., In re Andover Togs, Inc.*, 231 B.R. 521 (Bankr. S.D.N.Y. 1999). A number of courts, however, apply the percentage to the total time remaining on the lease. *E.g., In re Connectix Corp.*, 372 B.R. 488 (Bankr. N.D. Cal. 2007).

In addition to claims for rent under Section 502(b)(6), landlords may assert claims for other obligations that may not be in the nature of rent, such as claims for compensation for physical damage to the premises, breach of maintenance and repair obligations, or other amounts.

The statutory cap on the rent under section 502(b)(6) of the Bankruptcy Code is designed to compensate the landlord while limiting large rent claims that would deplete the debtor-tenant's estate to the detriment of other creditors. There has been a split in the reported cases on what constitutes allowable "rent reserved" by the lease for purposes of a claim under section 502(b)(6), and whether the Bankruptcy Code even permits a landlord to file claims under the lease for obligations other than "rent reserved" within the meaning of section 502(b)(6). *Compare, e.g., In re Best Prods. Co.*, 229 B.R. 673 (Bankr. E.D. Va. 1998), with *In re Smith*, 249 B.R. 328 (Bankr. S.D. Ga. 2000). Several recent cases suggest a trend toward a narrow view of the scope of "rent reserved" which, in turn, should leave landlords free to file unsecured claims for other items due under the lease without running afoul of the statutory cap for the additional amounts. *E.g., Saddleback Valley Comm. Church v. El Toro Materials Co.*, 504 F.3d 978 (9th Cir. 2007)(landlord's costs of removing debtor's equipment and waste from leased property was not limited by the statutory cap); *In re Foamex Internat'l, Inc.*, 368 B.R. 383 (Bankr. D. Del. 2007)(landlord's claim for breach of repair and maintenance covenant in lease was not "rent reserved").

POSSIBLE CRACKS IN THE ARMOR OF L/C INDEPENDENCE • In *In re Stonebridge Technologies, Inc.*, 430 F.3d 260 (5th Cir. 2005)(per curiam), a Chapter 11 reorganization case, the U.S. Court of Appeals for the Fifth Circuit held that the statutory cap on a landlord's claims for prospective unpaid rent under section 502(b)(6) of the Bankruptcy Code applies only in the case of a formal claim that is actually filed by the landlord with the bankruptcy court. In connection with the debtor's rejection of an unexpired lease of commercial realty, the landlord drew down the L/C given by the tenant as security under the lease. The proceeds far exceeded the then-outstanding unpaid obligations due under the lease but were less than the accelerated amount of rent reserved for the balance of the lease. The landlord did not file a proof of claim for its rejection damages in the bankruptcy case.

The post-confirmation liquidating trustee filed a lawsuit against the landlord, claiming that the

landlord breached the lease, made negligent misrepresentations to the issuing bank, and prematurely drew down the L/C. Denying the trustee's request to recover the amount of the L/C proceeds that exceeded the statutory cap for prospective rent claims under section 502(b)(6), the court held that the landlord was entitled to retain all of the funds and to apply them to the contractual obligation even though the landlord did not assert a formal claim in the bankruptcy proceeding. The court further held that the acceleration clause of the lease justified the landlord's draw, receipt, and retention of the complete L/C proceeds and their application to the contractual damages. Finally, the court determined that the landlord did not prematurely draw down the funds, in that it waited until after the occurrence of a default under the lease to present the L/C for payment (in this case, the rejection of the lease, which constituted the equivalent of a prepetition material breach). Accordingly, the L/C draw was supported by a lease provision under which the landlord was rightfully entitled to the funds.

Dispute Controlled By Filing Or Non-Filing Of Proof Of Claim

The *Stonebridge* decision rests on the distinction between the landlord's contractual entitlement to payment for which no proof of claim is filed in the bankruptcy case (i.e., all accelerated rent for the balance of the lease), and the statutory claim for prospective rent which is subject to the cap in the event that the landlord actually filed a claim in the bankruptcy case. The court emphasized that "the claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all.... [T]he damages cap of §502(b)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter of credit unless and until the lessor makes a claim against the estate." 430 F.3d at 270 (emphasis added; citation omitted). Thus, there can be two very different outcomes under *Stonebridge*:

- If the landlord refrains from filing a proof of claim the landlord may retain the proceeds of the L/C even if they exceed the statutory limits of the claim for prospective unpaid rent under section 502(b)(6). As a general rule, a creditor may not receive a distribution from the bankruptcy estate of a Chapter 11 debtor unless it has filed a proof of claim which has been allowed, or its claim has been scheduled by the debtor as an undisputed claim in an amount that the creditor does not challenge. In a Chapter 7 case, a creditor typically must file a proof of claim to share in distributions from the estate even if it does not question the scheduled amount. In the Stonebridge situation, the landlord did not file a proof of claim and thus was not entitled to receive any payment from the estate. Under Stonebridge, however, the L/C proceeds did not constitute estate property, so that the landlord could retain those funds without running afoul of restrictions under the Bankruptcy Code that enjoin a creditor from exercising control over estate property, and without affirmatively seeking any recovery from the estate. S*ee also In re Farm Fresh Supermarkets of Md., Inc.*, 257 B.R. 770 (Bankr. D. Md. 2001) (landlord drew L/C proceeds in an amount that exceeded the section 502(b)(6) cap; bankruptcy court lacked jurisdiction to entertain the debtor's attempt to recover the funds because the L/C and its proceeds were not property of the estate); I*n re Darwin Networks Inc.*, Adv. Proc. No. A01-4601 (Bankr. D. Del. Aug. 24, 2001) (order granting partial summary judgment), discussed in Geoffrey L. Berman, Peter M. Gilhuly & Shira Roth, *Landlords Use Letters of Credit to Bypass the Claim Cap of § 502(b)(6),* 20 Am. Bankr. Inst. J. 16 (Dec. 2001-Jan. 2002);
- In contrast, the landlord's filing of a proof of claim against the debtor—whether filed before or after rejection of the lease—will operate as a submission to the jurisdiction of the bankruptcy

court to adjudicate all aspects of the creditor-debtor relationship with the debtor-tenant. See Langencamp v. Culp, 498 U.S. 42 (1991). If the landlord actually files a proof of claim in the bankruptcy case, the court will have jurisdiction to limit the landlord's claim to the statutory cap. In that event, under prevailing jurisprudence, the L/C proceeds likely will be applied to the statutorily capped claim in the first instance. *E.g., In re AB Liquidating Corp.*, 416 F.3d 961 (9th Cir. 2005); *In re PPI Enters.* (U.S.), Inc., 324 F.3d 197 (3d Cir. 2003). (The courts justify this application of L/C proceeds to the statutory cap in order to reduce the estate's reimbursement obligation to the issuing bank under the L/C.) Any excess funds held by the landlord will be subject to recovery by the bankruptcy estate. Conversely, any deficiency in the capped claim after application of the L/C proceeds would remain entitled to ratable treatment with other general unsecured claims.

One commentator suggests that the debtor or bankruptcy trustee may circumvent Stonebridge and reach the excess L/C proceeds by filing a lease rejection claim for the landlord under section 501(c) of the Bankruptcy Code and Rule 3004 of the Federal Rules of Bankruptcy Procedure, which authorize the debtor or trustee to file a proof of claim for a creditor who does not timely file a proof of claim in the case. Gregory G. Hesse, *Letters of Credit and Leasehold Rejection Damages*, 25 Am. Bankr. Inst. J. 20 (Mar. 2006). While this arguably would allow the debtor or trustee to file a proof of claim in place of the creditor-landlord that does not file its own claim, there are no reported cases known to this author that involve the precise situation. Moreover, given that the estate's alleged right to the excess L/C proceeds would be in the nature of a counterclaim to the underlying rent claim seeking recovery of money or property (which must be pursued by an adversary proceeding instead of by claim objection (see Fed. R. Bankr. P. 3007(b), 7001(1)), there is a question as to whether the debtor's or trustee's filing of a proof of claim for the creditor-landlord will establish jurisdiction for the bankruptcy court to adjudicate the estate's entitlement to those proceeds where the creditor did not voluntarily submit to the court's jurisdiction by actually filing its own proof of claim. *Compare Marcus Dairy, Inc. v. Belford (In re Naugatuck Dairy Ice Cream Co.)*, 106 B.R. 24 (Bankr. D. Conn. 1989) (holding that trustee may not file proof of claim for the creditor in order to confer jurisdiction to decide estate's counterclaim against creditor), with Stonebridge, 430 F.2d at 265-67 (finding jurisdiction in the bankruptcy court to consider the post-confirmation liquidating trustee's complaint in a separate adversary proceeding against landlord as "related to" the bankruptcy case under 28 U.S.C. §1334(a)). In any event, as further discussed below, if the exercise of jurisdiction over a debtor's or trustee's claim to L/C proceeds is sustained, the landlord may find itself defending on the merits in the bankruptcy court even when it has not otherwise taken steps deliberately to subject itself to the court's jurisdiction.

The *OneCast Media* Case: Debtor-Tenant's Contractual Rights Under Lease Trump Landlord's Draw Under L/C That Exceeded Statutorily-Capped Claim

In the slightly later case of *In re OneCast Media, Inc.*, 439 F.3d 558 (9th Cir. 2005), a Chapter 7 liquidation case, the tenant secured its obligations to the landlord in the form of cash and an L/C. The lease specifically provided that both the cash and the L/C comprised a security deposit, and that any portion of the security deposit in excess of the landlord's damages for breach of the lease was to be returned to the tenant. After the debtor rejected the lease, the landlord drew down the full security deposit including the L/C, applied the funds to outstanding rent and other unpaid obligations, and retained all of the remaining proceeds. The landlord apparently did not file a proof of claim in

the bankruptcy case for prospective unpaid rent or any other amounts. (The published opinion makes no reference to such a filing.) The U.S. Court of Appeals for the Ninth Circuit held that, notwithstanding the rejection of the lease, the Chapter 7 trustee for the tenant could maintain a contract action against the landlord to recover the amount of the L/C proceeds that exceeded the landlord's contractual damages under the lease.

Dispute Controlled By Lease Terms

Although the court in OneCast recognized the independence principle for L/Cs, it held that the dispute was controlled by the landlord's contractual entitlement to the security deposit under the lease, not by the terms of the L/C, and that the Chapter 7 trustee's interest in those funds under the contract was property of the bankruptcy estate. Even though the lease had been rejected, the court held that the trustee was entitled to maintain an action on the underlying contract between the L/C purchaser (the tenant) and the beneficiary (the landlord). The OneCast court rested its conclusion, in part, on the rationale that "rejection" of an unexpired lease pursuant to section 365 of the Bankruptcy Code does not constitute "termination" of the lease, and thus does not divest the bankruptcy estate of its contractual rights under the lease. The court also emphasized that the case was not controlled by jurisprudence under the independence doctrine respecting a bank's or an account party's anticipatory attempt to enjoin an L/C beneficiary from drawing on the instrument. The possible statutory rent claim under section 502(b)(6) of the Bankruptcy Code did not enter into the court's decision.

A debtor's cause of action for breach of a contract to which the debtor was a party is property of the bankruptcy estate. "What is at issue here is simply the controversy between the Landlord and the Trustee over how much of the funds held by the Landlord it is entitled to retain.... The Trustee's interest in those funds is property of the estate." 439 F.3d at 564. On that basis, the OneCast court would allow the bankruptcy trustee to seek recovery of the landlord's excess recovery on a contract basis even when a landlord did not actually file a proof of claim in the bankruptcy case. The exact parameters of such relief, especially in the judicial circuits outside of the OneCast court, however, remain to be developed through further case law.

The *Builders Transport* Case: Further Support For Relying On The Debtor-Tenant's Contractual Rights Under Rejected Lease To Reach Excess L/C Proceeds

The evolution of the law in this area continued with the decision of the U.S. Court of Appeals for the Eleventh Circuit in *In re Builders Transport, Inc.*, 471 F.3d 1178 (11th Cir. 2006), cert. denied, 127 S. Ct. 2112 (2007). There, the court upheld a debtor's turnover claim against its lessor and the lessor's secured assignee to recover L/C proceeds retained by the assignee in excess of the damages to which the lessor would have been entitled under state law for termination of the lease. The court held that the L/C independence doctrine did not insulate the defendants from liability, distinguishing the distribution of the L/C proceeds from the contractual rights of the debtor-tenant and its landlord under the lease. The debtor's turnover action "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." Id. at 1192-93. Under this rationale, the court also concluded that its decision did not conflict with *Stonebridge* for two reasons:

- First, the debtor had a common law action against the defendants to challenge the alleged "unlawful retention" of the L/C proceeds;
- Second, the rejection damages cap under section 502(b)(6) was not actually applied in *Builders Transport.*

Id. at 1193 n.12. The court also concluded that, contrary to the beneficiaries' contention, the lease and L/C documents did not establish that the L/C was intended to secure the tenant's obligations under the leasehold mortgage. Id. at 1187-90.

The court, surprisingly, never mentioned *OneCast* to support its determination that the L/C proceeds, once distributed, could be reached through a conventional breach of contract claim. Instead, the court cited two earlier appellate decisions to support its conclusion on this point, neither of which involved an L/C-backed lease: *In re Graham Square, Inc.*, 126 F.3d 823, 827 (6th Cir. 1997)(independence doctrine protects only the distribution of L/C proceeds (also cited in the *OneCast* decision), and *Resolution Trust Corp. v. United Trust Fund, Inc.*, 57 F.3d 1025 (11th Cir. 1995)(irrevocable L/C does not nullify obligations in the underlying contract, which becomes relevant to determine which parties have the right to proceeds drawn under the L/C).

The addition of this decision to the reported jurisprudence increases the likelihood that debtor-tenants will resort to their contract-based remedies under state law to avoid the effect of the L/C independence doctrine.

SOLUTIONS? • Although there is almost no reported case law that specifically addresses the *Stonebridge*, *OneCast* and *Builders Transport* decisions, the lesson of these cases – pending further development of the jurisprudence – is that, when faced with a bankrupt tenant who furnished an L/C to secure its lease, the landlord should seriously consider whether or not to file a proof of claim in the bankruptcy case. Submission to the jurisdiction of the bankruptcy court through the filing of a proof of claim for prospective unpaid rent will subject the landlord to the statutory cap under section 502(b)(6) of the Bankruptcy Code, and will expose it to the risk of having to pay back L/C proceeds in excess of the amount of that claim. Although there is no assurance that the debtor in possession or bankruptcy trustee will not otherwise attempt to recover the alleged excess proceeds, the landlord should occupy a stronger strategic position by not anticipatorily subjecting itself to the bankruptcy court's jurisdiction. In addition, by not filing a proof of claim, the landlord-creditor preserves its ability to seek a trial by jury if the debtor in possession or bankruptcy trustee commences litigation in the bankruptcy court to recover the alleged excess proceeds. *See Granfinanciera v. Nordberg*, 492 U.S. 33 (1989); *In re Orion Pictures Corp.*, 4 F.3d 1095, 1102-03 (2d Cir. 1993).

Although, as a technical matter, each of the *Stonebridge*, *OneCast*, and *Builders Transport* decisions controls the lower courts only in the respective federal judicial circuit in which the opinion was issued, the cases raise concerns that may well become significant in other bankruptcy venues and that are likely to generate additional litigation. Thus, even in absence of filed proofs of claim for lease rejection damages, debtors in possession and bankruptcy trustees can be expected to rely increasingly on contractual theories to challenge landlords' receipt and retention of L/C proceeds that were otherwise thought to be beyond the reach of the bankruptcy estate under the independence doctrine.

PRACTICE CHECKLIST FOR

Recent Developments In The Bankruptcy Treatment Of Letters Of Credit Under Commercial Real Estate Leases

The issues raised by the *Stonebridge, OneCast,* and *Builders Transport* cases should not dampen the appetite of landlords to obtain security for their leases, especially letters of credit ("L/Cs"). The uncertainties presented by the cases may be reduced, but not necessarily eliminated, by a number of options:

- Seek guarantees, L/Cs, or other collateral or assurances of payment from entities other than the debtor-tenant, because such third parties will be liable for payment of the landlord's entire damages without reference to the statutory cap on a rent claim against the tenant under Bankruptcy Code section 502(b)(6)(A);
- Avoid lease provisions that characterize an L/C as a security deposit or that require the landlord to remit any L/C proceeds to the tenant;
- Avoid lease provisions that condition a landlord's draw of the L/C on the tenant's consent or provision of documents from the tenant or that limit the amount that may be drawn;
- Avoid ipso facto bankruptcy clauses in the lease;
- Include provisions in the L/C that authorize the landlord to draw the L/C upon any default of the lease by the tenant—including non-payment of rent or any other obligation under the lease—or upon the failure of the tenant to renew the L/C by a prescribed time before its expiration;
- Minimize or avoid references in the lease to the L/C or its terms, if possible, while separately stating all of the operative terms and conditions governing the L/C and its proceeds in the L/C;
- Include a provision in the L/C that authorizes the landlord to draw the L/C at any time upon or following the commencement of a bankruptcy case by or against the tenant;
- Include lease provisions that make clear that the tenant has no property interest in the L/C or any of its proceeds;
- If the L/C is intended to secure obligations under a leasehold mortgage, whether separate from or in addition to the obligations under the lease, make sure that the loan and L/C documents clearly establish that purpose and the conditions under which a draw under the L/C is authorized for that purpose;
- Consider deferring any draw of the L/C until after either the clear occurrence of a breach of the lease or the entry of a bankruptcy court order authorizing the debtor-tenant's rejection of the lease;
- Because the filing of a proof of claim by the landlord constitutes the voluntary submission to the bankruptcy court's jurisdiction to adjudicate virtually all matters that bear upon the allowance and amount of the landlord's claim, there may be situations in which a landlord may be well advised simply to draw the L/C (in compliance, of course, with the terms and requirements of the governing documents), refrain from filing a proof of claim, and to take no action in the tenant's bankruptcy case.