

## Using Letters of Credit to Secure Lease Obligations

*Part One of a Two-Part Series*

By **Carter H. Klein**

For a relatively small fee and assuming sufficient collateral or creditworthiness of the tenant or a guarantor, a tenant may be able to apply for and have its bank issue to its landlord a letter of credit (“L/C”) to secure the tenant’s obligations under a long-term lease. If the L/C is large enough, the landlord may enter into a lease with a tenant that the landlord would otherwise refuse due to the tenant’s lack of creditworthiness. From the tenant’s perspective, an L/C may be preferable to a large security deposit. An L/C will not necessarily tie up large amounts of the tenant’s cash or other liquid collateral, as would a security deposit. Instead, the cash can be deployed as working capital in the tenant’s business.

An L/C is an independent obligation of the issuer. As long as conforming documents specified by the terms of the L/C are presented to the issuer before the expiration date and no fraud is involved, the issuer must honor. The credit of the issuer stands behind the obligation of the tenant. If the tenant is insolvent and/or bankrupt, the issuer still must honor the beneficiary’s conforming draws.

Even if the tenant disputes the claim

of the landlord that the tenant has defaulted in its lease obligations or the tenant disputes the amount of damages the landlord claims, the landlord can still draw on the L/C notwithstanding those defenses and claims. The parties must argue about or litigate the tenant’s claims outside of the draw and without involvement of the L/C issuing bank.

The strongly worded rule in Revised Article 5 of the Uniform Commercial Code (the “UCC”) which deals with letters of credit is that a draw under an L/C cannot be enjoined unless the applicant can show egregious fraud and all the conditions entitling the applicant to equitable relief have been fulfilled. Those conditions include showing probable success in proving fraud, irreparable harm, no adequate remedy at law, balance of the equities, and the public interest will be served. In appropriate cases, a bond must be posted by the applicant to preserve the rights the landlord will lose if the L/C draw is enjoined and the credit expires. Appellate case law follows the statute: It is very difficult to sustain a contested injunction against a facially conforming draw on an L/C. To further discourage injunction suits against draws on L/C which are really contract disputes, Revised Article 5 requires the unsuccessful party in an action to enjoin a draw on an L/C to pay the prevailing parties’ attorneys’ fees.

Finally, if both the lease and the L/C are drafted properly, an L/C can be

drawn upon and the proceeds applied to obligations under the lease notwithstanding the bankruptcy of the tenant. The automatic stay in bankruptcy does not apply to draws on a letter of credit because courts consider the draw is against funds of an independently obligated issuing bank and not an attempt to realize on property of the bankrupt debtor. An L/C thus has an advantage over cash collateral, because a landlord must obtain relief from the automatic stay from the tenant’s bankruptcy court to apply a cash security deposit to unpaid lease obligations. Further, if a tenant is in arrears on his rent when he files for bankruptcy, the draw on the letter of credit to pay the arrears will not be regarded as a preference in bankruptcy. This two-part article provides tips for drafting L/Cs. Part one includes a discussion of using the International Standby Practices, keeping the draw conditions simple and allowing partial draws. The conclusion addresses issues such as providing coverage of the settlement period after lease termination; shortening the time period to honor; and using a transferable L/C.

### **LETTER OF CREDIT DRAFTING TIPS** *Use the ISP Instead of the UCP*

The type of L/C securing lease obligations is a standby L/C as opposed to a documentary or commercial L/C used to pay for goods purchased in international trade. A standby L/C is

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drawn upon if a default occurs and a certificate of default signed by the landlord as called for by the L/C is presented to the issuer. Besides Article 5 of the UCC, there are two principal regimes that govern letters of credit in this country: the Uniform Customs and Practice for Documentary Credits promulgated by the International Chamber of Commerce ("ICC") effective Jan. 1, 1994, and found in ICC Publication No. 500 (the "UCP") and the International Standby Practices 1998 promulgated jointly by the Institute for International Banking Law and Practice and the International Chamber of Commerce, effective Jan. 1, 1999 and found in ICC Publication No. 590 (the "ISP").

From the landlord's perspective as beneficiary, the preferred governing regime for an L/C taken in lieu of a security deposit should be the ISP. It is specifically designed for standby letters of credit, has clearer rules on questions involved in standbys, including assignment of proceeds and transfers of the L/C itself, and avoids several traps for the unwary found in the UCP. Those traps include: 1) if the issuer is closed while the L/C expires due to a force majeure event, the beneficiary cannot effect a draw, 2) if installment drawings are contemplated and one is not made, the beneficiary cannot make subsequent drawings, 3) if transport documents are to be presented, they must not be stale, and 4) documents cannot be inconsistent with one another. Under the ISP, each of these troublesome pitfalls is eliminated. For example, if the issuer is closed when the credit expires due to a force majeure event, the beneficiary under an ISP-governed credit has an additional 30 days to make a presentment from the day the issuer reopens. By incorporating the ISP into an L/C, there is no need to worry about drafting additional terms in the L/C to avoid the pitfalls contained in the UCP. If you request them, most banks will issue standbys governed by the ISP.

### ***Keep the Draw Conditions Simple***

A landlord is better able to make an error-free draw if the L/C it receives from the tenant's bank: 1) calls for few documents, 2) minimizes the verbiage in the documents to be presented, and 3) does not require the wording of the draw documents specified in the L/C to be verbatim or exact language.

The simplest form of presentment is a draft or demand without any other documents, statements or certificates accompanying it. It is also the most difficult presentment to enjoin and is the easiest presentment to comply with without making a mistake. For avoiding the applicability of the automatic stay in bankruptcy, presentment of only a draft or demand is desirable from the landlord's viewpoint because it does not require declaration of a default or certification that notice of default or demand for payment has been given to the now bankrupt tenant. Of course, any tenant's lawyer worth his or her fee will strongly resist use of an L/C that calls only for presentment of a draft or demand to effect a draw and will negotiate requirements that the landlord give various notices and declarations before the landlord can draw on the L/C. A reasonable compromise is a default certificate by the landlord stating that the tenant is in default of the terms of the lease, that under the lease the landlord is entitled to draw on the letter of credit, and that the amount of the draw does not exceed the amount to which the landlord is entitled under the lease.

### ***Avoid Documents Not Within the Landlord's Control***

Avoid as a draw condition presentment of any certificate or document that must be signed by the tenant, a court or an arbitrator or any third party over which the landlord has no control. Although the Northern District of Illinois required a bankrupt Kmart to sign a required draw document to enable a landlord to draw on a letter of credit securing a settlement for unpaid rent, several cases have held that where the tenant is required to sign a document to effect a draw, once the

tenant is in bankruptcy it is no longer required to do so.

### ***Allow Partial Draws***

The landlord should be able to make partial draws on the L/C and multiple draws on the L/C. Although that is the default rule under the UCP and the ISP, it is better expressly to so state — "Multiple drawings allowed/Partial drawings allowed."

### ***Avoid Specification of Use of Funds***

The landlord should not be required to specify the use or deployment of the funds drawn on an L/C other than in a very general nature, such as pursuant to the terms or on account of a default under the lease.

### ***Provide for Coverage of a Settlement Period After Lease Termination***

Optimally, the L/C should have an outside or final expiration date beyond the expiration of the lease to allow the landlord to calculate and recover damages to the premises, holdover rent, and avoid or protect against a bankruptcy of the tenant within 90 days of the last payment received under the lease, if received late. The latter concern would require: 1) using a claw-back provision in the L/C, and 2) requiring expiration of the L/C more than 90 days beyond the last anticipated payment date to cover the preference period, or alternatively, use of a direct pay L/C to recover the final amounts due under the lease. Many landlords will not have the bargaining leverage to require the tenant to continue to post an L/C for 90 days following the final lease payment.

The conclusion of this article will provide six more drafting tips and a discussion of the issuing banks' concerns.



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