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TENANT LETTERS OF CREDIT; BANKRUPTCY ISSUES FOR LANDLORDS AND THEIR LENDERS

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I. INTRODUCTION [2]

Mortgage lenders often make loans secured by real property that is owned by an entity (the "landlord") that leases the property to one or more tenants. Landlords customarily have received cash security deposits from tenants, which they have pledged to their mortgage lenders as partial security for their real property loans. It has become increasingly common for landlords to obtain security deposits in the form of letters of credit. [3] Letters of credit offer certain advantages over traditional security deposits. Most notably, when properly structured and drafted, letters of credit and letter of credit proceeds are not property of the tenant and do not become property of the tenant's bankruptcy estate. On the other hand, the structure of a letter of credit transaction is more complex than a traditional security deposit, and more actions are required after delivery to recover funds under a letter of credit.

This article addresses the rights in a tenant's bankruptcy case of a landlord that has received one or more letters of credit from the tenant to support that tenant's obligations under its lease, as well as certain rights of the landlord's mortgage lender. Part I provides an overview of the legal principles applicable to the analysis: the basic structure and use of letters of credit, and of the Bankruptcy Code provisions relating to real property leases and landlords' claims. Part II addresses potential advantages a landlord may enjoy in a tenant's bankruptcy case when the tenant's lease is supported by a letter of credit rather than a traditional security deposit.

This article provides general guidance; it is important to note that a bankruptcy court's ruling on the rights of the debtor−tenant and its creditor−landlord (and/or the landlord's lender) will be based on the actual terms of the lease, letter of credit, and reimbursement agreement in question, the actual facts and circumstances before the court, and applicable state and other nonbankruptcy laws, [4] as well as the interpretations and applications of the Bankruptcy Code in the federal circuit where the bankruptcy court is located.

II. LETTERS OF CREDIT AND BANKRUPTCY − GENERAL PRINCIPLES

A. Letters of Credit

1. Overview of Transaction Elements

A letter of credit transaction generally involves three parties and three contracts. [5] Where a landlord receives an irrevocable standby letter of credit to secure a tenant's lease obligations, the parties are the tenant, as account party, the landlord, as beneficiary, and the issuer of the letter of credit, usually a bank. [6] The three contracts are the lease between the tenant and the landlord, [7] the letter of credit between the landlord and the issuer, [8] and the reimbursement agreement between the tenant and the issuer. [9] Letters of credit generally are governed by Article Five of the Uniform Commercial Code [10] as and to the extent adopted by any state, and to the extent expressly incorporated into any letter of credit, Uniform Customs and Practice for Documentary Credits, International Chamber of Commerce Brochure No. 500, [11] and/or the international Standby Practices.

[12]

Generally, in transactions involving a mortgage lender, the landlord may receive a letter of credit to support performance and payment of the tenant's obligations under the lease instead of a security deposit in the form of cash or a certificate of deposit. [13] Accordingly, in addition to entering into the lease with the landlord, the tenant will procure the issuance of an irrevocable letter of credit in favor of the landlord, which will create a relationship between the landlord and the issuer independent of the lease. [14] To obtain this letter of credit, it will be necessary for the tenant to enter into a reimbursement agreement with the issuer. Each of these documents creates discrete contractual relationships and distinct rights and obligations.

In addition to the terms and conditions of the letter of credit itself, the terms of the lease, as well as state law applicable to the landlord−tenant relationship, will determine whether, when, and in what amounts the landlord will be entitled to draw under the letter of credit and retain letter of credit proceeds. [15] Presumably, the landlord will be allowed to draw against the letter of credit for the same reasons and purposes as it would be able to charge against a traditional security deposit, and also may be able to draw for reasons and purposes that would not be chargeable against a traditional security deposit. The lease terms also will affect, and should define, the rights of the landlord to apply and/or retain amounts drawn under the letter of credit, together with any obligation of the landlord to pay over to the tenant any amounts drawn under the letter of credit. [16] A landlord will want broad rights to draw under a letter of credit and retain all drawn amounts; a tenant will want to limit the landlord's draw and retention rights. Unless the terms of the lease are drafted carefully, the tenant may be able to rely on the language of the lease, and facts surrounding the landlord's demand for a draw, before or during the tenant's bankruptcy case, to either seek an injunction of the draw, or pursue a claim against the landlord for improperly drawing under the letter of credit or otherwise breaching the lease. [17]

The letter of credit itself should specify the terms and conditions on which draws can be made. [18] These terms and conditions are subject to negotiation among the landlord, the tenant, and the issuer. From the landlord's perspective, a letter of credit optimally should provide that draws may be made upon presentation to the issuer of either (a) nothing but the original letter of credit, or (b)(i) the original letter of credit together with (ii) a written statement that (x) the landlord is entitled to the draw pursuant to the terms and conditions of the lease, or (y) the tenant, or its successors or assigns, has not provided a satisfactory standby letter of credit more than 60 days prior to the expiration date of this letter of credit from an issuer that is acceptable to beneficiary and with a maturity date and other provisions which are acceptable to beneficiary, or (z) the tenant, or its successors or assigns, is a debtor in a case under the Bankruptcy Code. Neither the letter of credit nor the lease should require the landlord to make any demand upon or give any notice to the tenant as a condition to making a draw under the letter of credit. [19]

In order to draw under the letter of credit, the landlord must present the required documents to the issuer in strict compliance with the specified terms and conditions. The issuer must honor a conforming presentation regardless of any breach by the landlord of the underlying contract between the landlord and the tenant. [20]

The reimbursement agreement governs the relationship between the tenant and the issuer. Generally, this agreement will require the tenant to pay a fee for issuance of the letter of credit. It also will establish the terms on which the tenant must reimburse the issuer for costs incurred with respect to the letter of credit and payments made thereunder, and will assess related interest and fees. The tenant will not be permitted to assert any breaches by the landlord under the lease as a defense to the tenant's reimbursement obligations to the issuer.

2. Draws Under Letters of Credit; the Independence Principle

The most important aspect of a letter of credit is that, unlike a traditional cash security deposit, a properly structured and drafted letter of credit, and any draws made thereunder, should not be deemed to be the tenant's property or part of its estate in the event the tenant becomes a debtor in a bankruptcy case. [21] Although the tenant pays the issuer a fee to issue the letter of credit for the benefit of the landlord, neither the letter of credit nor payments thereunder becomes property of the tenant's bankruptcy estate. [22] Thus, draws and payment

under a letter of credit should not be barred by the automatic stay imposed by section 362(a) [23] in the debtor's bankruptcy case. [24] This independence principle is the cornerstone of letter of credit law:

[A]n issuer's obligation to the letter of credit's beneficiary is independent from any obligation between the beneficiary and the issuer's customer. All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all the duties required by the letter of credit. Any disputes between the beneficiary and the customer do not affect the issuer's obligation to the beneficiary to pay under the letter of credit. [25]

The letter of credit should be drafted so that the landlord's ability to draw thereunder is not impaired by the tenant's bankruptcy filing. The landlord should be able to draw under the letter of credit whenever the tenant (which should be identified generically in the lease as the tenant, not by specific name, and should include all successors and assigns, and any of them) is not in compliance with the terms and conditions of the lease. The landlord also needs to be able to draw under the letter of credit upon the commencement of the so−described tenant's bankruptcy case. A landlord may need to rely on this provision when the tenant otherwise is in compliance with all terms and conditions of the lease from and after the commencement of the tenant's bankruptcy case. This condition must be stated in the letter of credit in order to be enforceable. [26] If it is in the lease, the court may refuse to recognize as a default the tenant's noncompliance with a prohibition against filing bankruptcy. [27] Such prohibitions generally are unenforceable ipso facto clauses. [28]

Of course, if the landlord can rely on the tenant's nonperformance of other obligations under the lease, it should do so. Even though the tenant is not a party to the letter of credit, the tenant may try to argue that terms of the letter of credit that permit a draw merely because the tenant is in bankruptcy are unenforceable ipso facto clauses. [29] Such other obligations include, but obviously are not limited to, timely payment of rent, timely payment of common area charges, repair and maintenance of the property in conformance with agreed standards, payment of taxes, and maintenance of adequate insurance with the landlord (and its mortgage lender) named as additional insureds. [30]

Additionally, the landlord should be able to draw under the letter of credit without the tenant's cooperation. For example, the draw should not be conditioned on the presentation of documents that must be executed by the tenant, as the landlord cannot compel execution by a tenant in bankruptcy. [31] Similarly, draws should not be conditioned on the landlord's prior notice of default, notice of acceleration, or demand on the tenant for payment; upon commencement of the tenant's bankruptcy case, default notices, notices of acceleration, and demands for payment for amounts due pre−bankruptcy are stayed by section 362(a). [32]

3. Injunction of Draws

Even though the automatic stay does not apply, some bankruptcy courts nonetheless have temporarily enjoined payment under a letter of credit or disbursement of letter of credit proceeds where the debtor was the account party. [33] The most notorious case, Twist Cap, Inc. v. Southeast Bank of Tampa (In re Twist Cap), [34] involved a temporary injunction of a draw by two beneficiaries, whose claims against the debtor otherwise were unsecured, under three letters of credit where the issuer's right to reimbursement was secured by property of the debtor. [35] The Court was concerned that, upon honoring the draws, the issuer's secured claim would replace the three unsecured claims, implicitly to the detriment of other creditors. [36] Additionally, the Court believed that payment of the unsecured claims by means of draws on the letters of credit "would amount to an impermissible preferential treatment of these two unsecured creditors which is contrary to the scheme of Chapter XI [sic] and would certainly be counterproductive to the debtor's efforts to obtain rehabilitation." [37]

It is now widely accepted that the mere fact that a draw effectively converts an unsecured claim against the debtor (i.e., the claim of the beneficiary−creditor) into a secured claim against the debtor (i.e., the reimbursement claim of the issuer−creditor) is not a reason to enjoin the draw. [38] Since Twist Cap, some courts have found that they absolutely "lack[] subject matter jurisdiction to enjoin payment or distribution of proceeds under the letter of credit contracts to which the Debtors were not parties." [39] Despite the broad

rejection of Twist Cap, there is still a risk that a court may enjoin a post−petition draw under a letter of credit, at least for a short period, upon finding special circumstances. [40]

4. Recovery of Amounts Drawn − Breach of the Lease; Preferences

Although payments to a beneficiary pursuant to a draw under a letter of credit should not be deemed to be property of the account party−debtor, the account party nonetheless may be able to recover some payments from the beneficiary. An account party can always sue a beneficiary to recover amounts that the beneficiary collected under the letter of credit but was not entitled to collect under the underlying contract between the beneficiary and the account party. [41] Thus, the terms of the lease may provide a basis for the tenant to recover damages from the landlord for all or some of the amounts drawn by the landlord under the letter of credit.

Draws made under a letter of credit that was issued during the preference period may constitute preferential payments avoidable under section 547 and recoverable by the account party−debtor for the benefit of its estate. [42] In Compton, the beneficiary of the letter of credit received the letter of credit within 90 days of the debtor's bankruptcy case and on account of an existing unsecured claim of the beneficiary against the debtor. [43] In order to procure the letter of credit, which the bank issued pursuant to an existing secured line of credit agreement with the debtor, the debtor pledged additional collateral to the bank. [44] The court found that the asset pledge was a transfer of property of the debtor, within 90 days of bankruptcy, on account of an antecedent debt to the beneficiary that enabled the beneficiary to receive more than it would have received in the debtor's bankruptcy case if it had not obtained the letter of credit within the preference period. [45] The Compton court held that "a creditor cannot secure payment of an unsecured antecedent debt through a letter of credit transaction when it could not do so through any other type of transaction.... A secured creditor was substituted for an unsecured creditor to the detriment of the other unsecured creditors." [46]

To avoid the Compton problem, the landlord should obtain the initial letter of credit supporting a lease at the time it enters into the underlying lease; the issuance of the letter of credit should then be deemed to be part of a contemporaneous exchange for new value (i.e., the lease). [47] If a landlord must obtain a letter of credit at a later date, it should prohibit the tenant from collateralizing its reimbursement obligations to the issuer.

5. Transfers and Assignments

a. General transfer and assignment rights of letter of credit beneficiaries

A mortgage lender, in addition to requiring a pledge of all leases between the landlord−borrower and the landlord's tenants, is likely to require the transfer from the landlord of each letter of credit and/or an assignment of the proceeds of any letter of credit of which the landlord is the beneficiary. The landlord, as beneficiary under a letter of credit, may transfer its right to draw or otherwise demand payment or performance under a letter of credit only if the letter of credit so provides. [48] If the issuer's standard practice is to require an account party's consent to a transfer, the landlord should obtain the tenant's consent to a transfer to a mortgage lender or its designee at the time the letter of credit is issued or, if issued prior to the date of the loan transaction, as of that date. Concurrently with such consent, and to forestall any later effort by the tenant to revoke it, the tenant should acknowledge in writing that a mortgage lender is relying on, and materially is changing its position with respect to the landlord and the tenant as a result of such consent. A transfer generally is documented by the issuance of a replacement letter of credit. [49]

Rather than transferring the letter of credit to a mortgage lender, it may be possible to arrange for the letter of credit to be issued severally to both the landlord and a mortgage lender as beneficiaries, with either of them able to draw thereunder. However, this would result in the landlord retaining a degree of control over, and substantial rights in, the letter of credit in the event of the landlord's bankruptcy case. [50]

Of course, even if a mortgage lender is the sole beneficiary under the letter of credit, its rights to draw thereunder still may depend on the conduct of the landlord, as well as the tenant's performance under the lease. For example, if draws are limited by the lease to amounts actually due and unpaid, then a mortgage

lender may not be able to draw the entire amount of the letter of credit unless the landlord serves a notice of default and acceleration on the tenant. The desirability of acceleration, as well as the ability to accelerate, will depend on the terms of the lease and applicable bankruptcy and non−bankruptcy law. A mortgage lender may not be able to compel the landlord, for reasons including but not limited to the landlord's bankruptcy, or the fact that the landlord is current under its obligations to a mortgage lender despite the tenant's default, to serve such a notice.

In addition to transferring its right to demand payment or performance under a letter of credit, a beneficiary can assign its right to part or all of the proceeds of a letter of credit. [51] The rights of an assignee to proceeds of a letter of credit (also known as "letter of credit rights") [52] are subordinate to the rights of a transferee beneficiary. [53] To assure that it has a senior security interest in letter of credit rights, the mortgage lender should perfect the security interest by obtaining "control." [54] This is done by obtaining the issuer's consent to the assignment. [55] An issuer cannot unreasonably withhold its consent if the secured creditor possesses and exhibits the letter of credit and draws are conditioned on presentation of the letter of credit. [56]

b. Delays in transfer of letters of credit; assignment of letter of credit rights

While the landlord's loan is in good standing, the landlord and a mortgage lender may decide to delay the transfer to a mortgage lender of the landlord's rights to draw or otherwise demand payment or performance under the letter of credit. Among other things, the delay of the actual transfer of the letter of credit to the mortgage lender may facilitate the landlord's access to the proceeds of the letter of credit. [57] This delay in effectuating the transfer exposes a mortgage lender to the risk that an actual transfer at a later date may be set aside in the landlord's bankruptcy case as a preferential transfer under Bankruptcy Code section 547. [58] There is a substantial risk that a court presiding over the landlord's bankruptcy case would find that the letter of credit was not transferred to the mortgage lender for purposes of section 547 until the mortgage lender had the right to draw under the letter of credit, and that, therefore, if made within 90 days of the landlord's bankruptcy case, the transfer could be set aside as preferential. [59]

The best way to prevent problems under section 547 is for a mortgage lender promptly to become a transferee beneficiary under each of the landlord's letters of credit. [60] If this is not practicable, a mortgage lender, as mortgage lender, may be able to mitigate its avoidance risks by perfecting its security interest in letter of credit rights as soon as possible. [61] Thus, concurrently with the making of the loan, a mortgage lender should obtain control of all then−existing letters of credit under which the landlord is the beneficiary. [62] A mortgage lender also should obtain control of each new letter of credit at the time the tenant−account party to such letter of credit executes its lease with the landlord. [63]

Notwithstanding these mitigative measures, a mortgage lender that has received an assignment of letter of credit proceeds remains vulnerable to certain attacks in the event the landlord−assignor becomes a debtor in bankruptcy. First, as long as the landlord is the beneficiary under the letter of credit, the letter of credit and proceeds thereof will be property of the landlord's bankruptcy estate. [64] Upon a showing that a mortgage lender's lien in the letter of credit proceeds (which are "cash collateral") [65] is "adequately protected," [66] the landlord may be permitted to use such proceeds in the course of its bankruptcy case. [67]

Second, section 552(a) generally provides that property acquired by the debtor after the petition date is not subject to any lien created by a pre−petition security agreement. [68] Accordingly, there is a substantial likelihood that a mortgage lender's security interest would not extend to letters of credit that the landlord receives after the landlord's petition date. (Moreover, any act by a mortgage lender to obtain control thereof pursuant to U.C.C. sections 9107 and 9314 would be stayed by section 362(a). [69] Similarly, a mortgage lender's perfected security interest in letters of credit delivered to the landlord before its petition date may not extend to payments received by the landlord pursuant to draws made under the letters of credit after the petition date. The outcome will depend upon whether "proceeds of a letter of credit" for purposes of U.C.C. section 5114 are within the scope of section 552(b)(l), and upon the bankruptcy court's interpretation and application of section 552(b)(l), as well as the extent to which the court finds, "based on the equities of the case," that it should not permit the lien of a pre−petition security agreement to extend to post−petition proceeds of pre−petition collateral. [70]

Third, if a mortgage lender is undersecured and the landlord becomes a debtor in bankruptcy, liens on leases and/or related letters of credit received within 90 days before the landlord's petition date may be avoided as preferential to the extent they increase the value of a mortgage lender's collateral to an amount greater than its value 90 days before the landlord's petition date. [71]

Fourth, it also must be noted that, if the landlord is still the beneficiary under the letter of credit at the time the landlord becomes a debtor in a bankruptcy case, a mortgage lender may not be able to compel the landlord to exercise its rights to draw under the letter of credit, even if the mortgage lender has perfected its security interest in letter of credit rights. [72]

For all these reasons, the collateral value of a mortgage lender's security interest in letter of credit rights may be limited in the event of the landlord's bankruptcy. However, a mortgage lender may find that these risks are outweighed by the benefits of having a tenant's properly structured letter of credit, rather than a cash security deposit, in the event of the tenant's bankruptcy, particularly where the landlord is a bankruptcy−remote entity. [73]

A. Reimbursement Agreements

The reimbursement agreement is the contract between the tenant and the issuer that governs the tenant's obligations to pay fees to the issuer for issuing the letter of credit, to reimburse the issuer for payments made to the beneficiary under the letter of credit, and related matters. [74] The precise rights of the issuer and the tenant are governed by the terms of the reimbursement agreement and applicable state law, and are independent of both (i) the rights and obligations of the tenant and the landlord under the lease and (ii) the rights and obligations of the issuer under the letter of credit (except the issuer's obligation only to honor demands for payment upon presentation of documents that comply strictly with the terms and conditions of the letter of credit). [75]

The issuer may require collateral to secure the tenant's reimbursement obligations, or may agree to issue the letter of credit on an unsecured basis. The issuer accordingly is treated as a secured or unsecured creditor in the tenant's bankruptcy case.

The primary advantage to the landlord of requiring the tenant to collateralize its reimbursement obligations is that collateralization can protect the landlord against exposure for preferential transfers. This exposure can arise if (i) the letter of credit is not secured, and (ii) the landlord, instead of drawing against the letter of credit as soon as rent has not been timely paid, receives a payment from the tenant for delinquent rent and, (iii) this delinquent rent payment is made within 90 days of the tenant's bankruptcy case. If all of these elements are present, the tenant's late payment could constitute an avoidable preference, which the tenant conceivably could recover from the landlord in the tenant's bankruptcy case after expiration of the letter of credit. [76] However, if the letter of credit is fully collateralized, then the tenant's payment of delinquent rent effectively results in a release of collateral under the reimbursement agreement of an equivalent value to the estate, and the landlord will not have to return the preferential payment. [77]

On the other hand, collateralization of the letter of credit could enable a court more readily to justify enjoining a draw under the letter of credit, pursuant to section 105, on the grounds that the debtor needs the underlying collateral for a successful reorganization. Although most courts roundly reject Twist Cap, which prevented a draw on a collateralized letter of credit where the underlying obligation was unsecured, some courts may feel inclined to limit the landlord's recourse to (or retention of proceeds under) a letter of credit where the landlord's unsecured claim is transmuted into a secured claim in favor of the issuer, or when the interest rate payable under the reimbursement agreement is substantially greater than the default rate under the lease. [78]

On balance, a landlord may prefer for the tenant's obligations under the reimbursement agreement to be fully secured, and for the landlord's letter of credit thus to be fully collateralized. However, the costs of collateralizing the letter of credit would include encumbering the tenant's assets and potentially impairing its cash flow and its ability to perform all of its obligations under the lease. These costs may be too great for this degree of protection to be practicable.

B. Leases

The lease is a contract between the tenant and the landlord. [79] It is governed by applicable state law and sets forth the respective rights and obligations of the tenant and the landlord, including with respect to such matters as the application and return of security deposits, the eviction of defaulting tenants and repossession of leased premises, and the determination of the elements of damages allowable upon a tenant's default. [80] Upon the commencement of a tenant's bankruptcy case, however, the tenant's rights under a lease, including any right to receive payments or refunds from the landlord, and the right to possession of the premises, become property of the tenant's bankruptcy estate. [81] At that time, provisions of the Bankruptcy Code, primarily the automatic stay imposed by section 362(a), temporarily prevent enforcement of the landlord's nonbankruptcy remedies. [82]

Careful attention in the lease to the letter of credit is essential to ensure that the landlord ultimately is able to enjoy all of the benefits of having obtained a letter of credit to support payment and performance under the lease. The lease should provide that the letter of credit is in lieu of a security deposit, [83] and should define the respective obligations of the tenant and the landlord with respect to the letter of credit. The tenant's obligations should include the obligation to procure the issuance of the initial letter of credit from an issuer and on terms and conditions acceptable to the landlord. [84] The tenant also should be required to procure the issuance of replacement or amended letters of credit concurrently with any change in the tenant's status, to assure that the terms and conditions of the draw are revised as necessary (with any appropriate corresponding amendments to the lease) to assure the continued ability of the landlord to draw under the letter of credit. Specific changes would include assignments of the lease or possessory rights thereunder to another person, either before or during a bankruptcy case of the tenant, [85] and the vesting of the lease in the tenant as a reorganized debtor or other successor emerging from bankruptcy. [86]

The lease also should clearly define all payment, performance, and forbearance obligations of the tenant, and provide that the landlord is permitted to draw against the letter of credit, in part or in full, upon the failure of the tenant, or its successor or assign, to comply with the terms and conditions of the lease. As discussed above, the precise terms of the lease should be drafted and negotiated carefully to maximize the landlord's ability to make and retain draws under the letter of credit. [87] To the extent possible, the noncompliance giving rise to the right to draw under the letter of credit should be defined as arising upon the tenant's nonperformance of any given obligation within a stated period after the due date, and without requiring any prior demand upon, notice to, or cooperation of the tenant. As a precaution, the lease should also specify that draws shall not cure any defaults relating to the noncompliance on account of which the landlord has drawn under the letter of credit, and shall not constitute waivers of such defaults by the landlord. [88] The lease also may require the tenant to restore or procure reissuance of the letter of credit within a short period after any draw, and may provide that only such restoration or reissuance can cure any default on account of which the landlord has drawn under the letter of credit.

The Bankruptcy Code contains special provisions relating to the performance or breach of leases of non−residential real property under which the debtor is the lessee (i.e., assumption or rejection) [89] , and the nature and amount of claims of landlords with respect to such leases. [90] In drafting the lease, consideration should be given to its construction in a future bankruptcy case of the tenant. There is little that can be done to alter the debtor's rights of assumption and rejection. However, definitions in the lease may affect calculation of the landlord's allowed claim upon rejection. It is not uncommon to denominate all of the tenant's obligations as "rent" or "additional rent," in order to facilitate recovery under state law. However, as is described in more detail below, a lease's denomination of items such as the tenant's obligation to repair and maintain the premises, or to pay the landlord's fees and costs incurred in enforcing the lease, as "additional rent" may impair a landlord's ability to recover such amounts if the lease is rejected in the tenant's bankruptcy case. [91] Additionally, in light of the cap that section 502(b)(6) imposes on a landlord's lease−related damages, some landlords have begun to document leasing and tenant improvements as separate transactions, with customary "rent" provisions retained in the lease, and the tenant improvement repayment obligation documented as a separate loan to the tenant, each secured by a letter of credit. Separateness can be enhanced by such measures as not cross−defaulting the lease and the tenant improvement note, providing different

maturity dates for each agreement (i.e., amortizing the tenant improvements over a shorter/longer period than the lease term), and collateralizing each agreement with a separate letter of credit. State law disadvantages may outweigh bankruptcy−related advantages to such a structure. Additionally, while such a strategy may preserve a landlord's ability to collect amounts in addition to "rent" in the event the lease is rejected, it increases the possibility that the lease may be assumed without the requirement that the debtor−tenant cure defaults relating to the separate loan obligation. [92]

C. Assumption or Rejection of Leases in Bankruptcy − Section 365

Leases of nonresidential real property that are in effect upon the commencement of a tenant's bankruptcy case are subject to special provisions of the Bankruptcy Code. Under section 365, a debtor can "assume" or "reject" a lease and, absent an extension of the deadline to assume or reject, must make its decision in the first 60 days of the bankruptcy case. [93] Assumption means that the debtor agrees and is authorized by the bankruptcy court order to perform all of its obligations under the lease for the remaining term of the lease, and confers administrative priority on all of the landlord's claims under the lease − the landlord is entitled to the same priority of payment of all amounts due under the lease, whether before or after commencement of the bankruptcy case, as the debtor's bankruptcy lawyers and other administrative creditors. [94] Rejection before a lease has been assumed constitutes a breach of the lease as of the commencement of the bankruptcy case and terminates the debtor's rights to possession of the premises. [95] The rejection of a lease may give rise to both general unsecured claims and administrative priority claims in favor of the landlord. [96]

1. Motions To Compel Assumption or Rejection

A tenant may file its bankruptcy petition before any defaults have occurred under the lease. As long as the letter of credit does not require demand upon or cooperation of the tenant as a condition to draws under the letter of credit, the landlord should be able to draw under the letter of credit in the event of any post−petition default under the lease. Additionally, if the letter of credit includes commencement of the tenant's bankruptcy case as the basis of a draw, and this is accommodated in the lease, the landlord should be able to draw under the letter of credit. At least one court has found that the Bankruptcy Code does not invalidate an agreement between nondebtor parties that a draw event is triggered by the debtor's bankruptcy or insolvency. [97]

It is possible, however, that the landlord will not be permitted to draw under the letter of credit in the absence of any default (other than the commencement of the tenant's bankruptcy case) under the underlying lease. [98] In such an event, it also may be possible that the existing letter of credit is scheduled to expire during the bankruptcy case and before the tenant's deadline to assume or reject the underlying lease. Presumably, the letter of credit or the lease will provide that, upon the tenant's failure timely to obtain a replacement letter of credit, the landlord can draw the entire amount of the letter of credit. If this is not the case, the landlord has one more avenue for relief − the landlord can make a motion to the bankruptcy court, pursuant to section 365(d)(2), for an order compelling the tenant to assume or reject the lease before the letter of credit expires. If the tenant rejects the lease pursuant to such an order, thereby breaching the lease as of the petition date, that breach, under the letter of credit and under the lease, should provide a basis for the landlord to draw down the letter of credit before it expires.

2. Assumption

A debtor is free to assume any unexpired lease, whether or not the debtor is in default thereunder. [99] In order to assume a lease under which it has defaulted, [100] however, a debtor must (a) cure or provide adequate assurance that it promptly will cure the default(s), (b) compensate or provide adequate assurance that it promptly will compensate the landlord for any actual pecuniary loss resulting from such default(s), and (c) provide the landlord with adequate assurance that the debtor will perform its obligations under the lease in the future. [101] Despite the statutory language, some courts have held that "prompt" payment of a cure amount may actually be made over an extended period of time. [102]

In addition to receiving cure payments, the landlord may be able to retain its rights in any existing security deposit, including proceeds of a letter of credit. [103] However, it is possible that events in the bankruptcy case, such as assumption of the lease by the tenant as debtor in possession, or the transmutation of the tenant into a "reorganized tenant" after confirmation of a plan of reorganization, could render the landlord unable to satisfy the conditions for drawing the letter of credit at a later date. To the extent possible (and it may be more difficult in the absence of any defaults under the lease), the landlord should require post−petition issuance of a new letter of credit as an essential element of "adequate assurance of future performance." [104]

3. Assignment

After assuming a lease pursuant to section 365(a) or (b), regardless of any restrictive language in the lease, a debtor can assign it to a third person if the court finds adequate assurance that such person will perform under the lease in the future. [105] If the tenant assigns the lease to a third party in the course of the tenant's bankruptcy case, pursuant to section 365(f), the tenant will not be liable for any defaults occurring under the lease after the effective date of the assignment. [106] As a result, it is arguable that no draw could be made under the tenant's letter of credit after the assignment date.

The landlord generally will be entitled to a security deposit (which may be of a greater or lesser amount than the original tenant's) from the replacement tenant as partial adequate assurance of its future performance. [107] The parties may arrange for the landlord to receive a new security deposit from the replacement tenant, or they may instead arrange for the replacement tenant's lease obligations to be secured by the existing security deposit. [108]

4. Landlord's Claims in a Tenant's Bankruptcy Case − Generally

A landlord's claim against a debtor may consist of several components with different priorities and limitations:

(i) Section 365(d)(3) requires the tenant to perform in full all of its monetary obligations under the lease from the petition date until the lease is assumed or rejected. [109] This obligation has administrative priority and generally is supposed to be paid in full as and when due. [110] If payment is delayed by court order or otherwise, the full amount eventually will be paid at some time during the case unless the debtor is "administratively insolvent;" i.e. unable to pay in full all costs of administering the estate in bankruptcy. If the debtor assumes the lease, the landlord's entire claim has administrative priority. [111] However, if the debtor rejects the lease, the landlord only has an administrative claim for the post−bankruptcy, pre−rejection period. [112]

(ii) The balance of the landlord's claims, for amounts due as of the petition date and amounts due as a result of rejection, constitute a pre−petition claim (subject to the cap imposed by section 502(b)(6), [113] payable pro rata with other general unsecured creditors (except to the extent that components of the claim are secured by a security deposit or other collateral, and are within the scope of the obligations covered by such collateral). [114]

5. Landlord's Damages upon Rejection

The actual amount of a landlord's claim for damages upon rejection of a lease is determined by reference to state law and the specific provisions of the lease. [115] For determining the amount of the claim to be allowed against the debtor−tenant and its bankruptcy estate, however, section 502(b)(6) caps the claim at something less than might otherwise be permitted.

Section 502(b)(6) caps the "claim of a lessor for damages resulting from the termination of a lease of real property" at an amount equal to the sum of (i) unpaid rent due under the lease as of the petition date (or earlier, if the lessee surrendered or the landlord repossessed the premises pre−petition) plus (ii) "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease," as calculated from the earlier of the petition date and any pre−petition surrender or repossession date. [116]

The purpose of the cap is to compensate landlords for losses they suffer upon termination of a lease and, at the same time, to prevent them from gaining a windfall, such as could arise from allowance of a claim for breach of a long term lease, at the expense of other unsecured creditors of the debtor. [117] Unfortunately, it is easier to define the purpose of the cap than the meaning of its specific words. Various courts have defined "rent reserved by such lease" and "damages resulting from ... termination" in ways that lead to disparate results. [118]

The phrase "rent reserved" has been the subject of extensive litigation. In the Ninth Circuit, the phrase has been construed to encompass all amounts payable under the lease, whether or not designated as "rent" or "additional rent". [119] However, only amounts that satisfy a three−part test may be allowed as "rent reserved" under the lease. [120] To qualify, (i) the charge must be designated as "rent," "additional rent," or an obligation of the tenant in the lease; (ii) "the charge must be related to the value of the property or the lease thereon," and (iii) "the charge must be properly classifiable as rent because it is a fixed, regular, or periodic charge." [121]

The McSheridan Court further ruled that a landlord only is entitled to recover "rent reserved" in the capped amount, and not to also recover damages arising from the tenant's pre−petition breach of covenants, despite contentions that such damages did not result from "termination" of the lease. [122] Thus, in the Ninth Circuit, a landlord is likely to be limited to a single claim based upon the amount of "rent reserved", and not to additional amounts for pre−petition breaches of other covenants, such as covenants to repair and maintain the premises. [123] Since McSheridan is an opinion of the Bankruptcy Appellate Panel, and not the Court of Appeals, landlords in the Ninth Circuit may still assert a claim for these additional amounts in the hope that the specific bankruptcy court they are appearing before does not believe itself to be bound by McSheridan. [124] Moreover, asserting the larger claim preserves a margin for negotiation, which is how most claims disputes are resolved.

The better reasoned approach is to allow a landlord a claim (in addition to any administrative claim) consisting of several components − pre−petition accrued, unpaid rent, plus termination damages in an amount equal to the "rent reserved" subject to the one−year/fifteen−percent−up−to−three−years cap of section 502(b)(6), plus damages for items that do not result from termination of the lease, such as for the value of property wrongfully removed by the tenant, or for the cost of maintenance and repairs necessitated by the debtor's failure properly to repair and maintain the premises prior to bankruptcy. [125]

Bankruptcy courts may exercise their discretion (subject to governing law in the relevant jurisdiction) in construing the "rent reserved" under a lease. A survey of caselaw reveals that "rent reserved" generally includes base rent, common area maintenance charges, utilities, insurance, and taxes, and generally excludes maintenance of specific premises as well as a landlord's attorneys' fees. [126] In addition to these amounts, which are subject to the rent cap, some courts have allowed landlords to recover damages arising from the debtor's pre−petition breach of specific covenants, such as the covenant to maintain the property. [127]

Some costs which are not allowable directly may be recovered indirectly. In the course of calculating the claim that is subject to capping under section 502(b)(6), the landlord is required to mitigate damages. [128] In calculating the mitigation amount by which its claim is to be reduced, a landlord may derive the lowest reasonable number by first calculating the amount of all payments to be received under the new lease for the balance of the term of the rejected lease, and then reducing that sum by all costs incurred in obtaining that sum (allocated pro rata over the term of the new lease). In that way, a landlord may indirectly recover a portion of tenant improvements, leasing commissions, and other concessions incurred with respect to the new tenant.

Once the landlord's allowed claim has been calculated in accordance with section 502(b)(6), the landlord's claim is reduced by the security deposit; the security deposit cannot be applied to recover actual damages in excess of the allowed claim. [129] If the amount of the security deposit exceeds the amount of the landlord's claim as allowed under section 502(b)(6), the landlord must return the excess amount to the debtor. [130]

I. DAMAGES UPON REJECTION OF A LEASE SUPPORTED BY A LETTER OF CREDIT

Where the lease is supported by a letter of credit, the landlord's recovery for damages upon rejection should not be limited by section 502(b)(6). The amount of the claim for damages upon breach of the lease still will be

calculated in accordance with applicable nonbankruptcy law. Additionally, the amount of the claim that is allowable as a claim in the tenant's bankruptcy case still will be calculated in accordance with section 502(b)(6). However, the landlord's rights to draw and retain letter of credit proceeds in excess of the cap amount should be determined in accordance with the terms of the lease, the letter of credit, and applicable nonbankruptcy law. Where a landlord's damages, as calculated under these agreements and applicable nonbankruptcy law, exceed the section 502(b)(6) cap, and the lease is supported by a letter of credit for an amount greater than the amount of the capped claim, the landlord should be able to draw and retain amounts under the letter of credit up to the amount permitted by the lease and applicable nonbankruptcy law, subject to application as required by such lease and nonbankruptcy law. This is true even though the amount drawn by the landlord exceeds the amount of the landlord's allowed claim in the tenant's bankruptcy case. [131] Moreover, where a landlord's claim under the lease exceeds the amount of letter of credit proceeds drawn by the landlord, the landlord should be allowed to assert a claim in the tenant's bankruptcy case for the amount permitted by section 502(b)(6), and should be able to collect distributions from the bankruptcy estate on account of the allowed claim until the sum of the letter of credit proceeds plus the bankruptcy distributions equals the amount of the landlord's claim as calculated in accordance with the lease and applicable nonbankruptcy law. [132] These amounts, of course, are in addition to any claim of the landlord for administrative rent under section 365(d)(3). Since section 365(d)(3) claims generally are payable in full in the ordinary course of the tenant's bankruptcy case, a landlord generally should not draw down the letter of credit to pay such rent unless it is abundantly certain that the amount of the letter of credit does and will exceed the maximum possible amount of the landlord's claim for breach upon rejection of the lease.

There does not appear to be any legal precedent that would support requiring a landlord to disgorge any portion of letter of credit proceeds on the basis of section 502(b)(6). However, a tenant may attempt to obtain an order of the bankruptcy court compelling the landlord to disgorge amounts drawn in excess of the cap imposed by section 502(b)(6), even if such amounts did not exceed the landlord's claim as calculated in accordance with the lease and applicable nonbankruptcy law. A court ignoring the independence principle conceivably could equate the letter of credit to a security deposit, and then determine that charges against the security deposit for a lease, whether property of the debtor or not, should not exceed amounts allowable under section 502(b)(6).

A landlord should prevail in the argument that the independence principle insulates it from section 502(b)(6) − its rights under the letter of credit are separate from the lease, and are against the issuer, not the debtor. Under this principle, so long as the terms and conditions of the letter of credit are satisfied, the landlord is permitted to draw thereunder. The landlord should not be required to pay any of those letter of credit proceeds to the tenant, except as and to the extent specified in the lease. [133]

The tension for the bankruptcy court is that the issuer of the letter of credit then will seek to exercise its rights under the reimbursement agreement to recover from the debtor all amounts drawn under the letter of credit. If the reimbursement agreement is enforced without reference to section 502(b)(6), as it ought to be, then the cap on the amount of the lease claim may be exceeded, at the expense of other creditors, and the landlord will have increased its claim through the use of a letter of credit in a way that it could not otherwise have accomplished. [134] In any event, the treatment of the issuer's claim against the debtor under the reimbursement agreement should have no bearing on the rights of the landlord under the letter of credit and to the letter of credit proceeds.

A landlord properly should be permitted to retain letter of credit proceeds in an amount greater than the amount of the landlord's allowed claim under the Bankruptcy Code, to the extent permitted in its lease with the tenant and under applicable nonbankruptcy law. However, because the result may be to increase substantially the amount of claims to be allowed against the estate, a bankruptcy court may favor creative arguments that could allow the tenant to recover from the landlord amounts drawn in excess of the allowed claim as calculated in accordance with section 502(b)(6). In addition to the potential prejudice to the estate or the issuer, the tenant could focus on the lease and the rights of landlords in bankruptcy. The tenant may argue that, so long as the letter of credit secures the tenant's obligations under the lease, the landlord's right to the security deposit is defined by the lease and applicable state law, as modified by the Bankruptcy Code. [135] If

the agreements have been properly drafted, this argument should not prevail.

The application of the independence principle, and the fact that the letter of credit proceeds are not property of the debtor, should be enough to prevent disgorgement of letter of credit proceeds. Nonetheless, disgorgement may be obtained in a less direct manner, as the facts and circumstances may impel a bankruptcy court to strive to find support for an affirmative recovery in favor of the tenant on the basis of alleged breaches by the landlord of the lease, or other allegedly wrongful acts of the landlord. An order compelling payment by the landlord to the tenant on such grounds would not appear to violate the independence principle.

II. CONCLUSION

The treatment of tenant letters of credit in bankruptcy is an emerging area of the law, and some courts may reach conclusions that are inconsistent with this article. However, a landlord who obtains letters of credit in support of tenant leases, masters letter of credit concepts, and drafts and enforces its leases and letters of credit with an eye to the Bankruptcy Code, should be able to emerge from its tenants' bankruptcy cases with a greater recovery than a landlord who accepts traditional security deposits for its leases. Mortgage lenders similarly may find that such letters of credit reduce the risk that defaults will occur under the landlords' mortgage loans upon their tenants' descent into bankruptcy.

FOOTNOTES:

[1] Ms. Winick is counsel with the firm of Mayer, Brown & Platt, resident in the Los Angeles Office. Back To Text

[2] Acknowledgments: My profound appreciation to my colleagues Alec G. Nedelman, Michael P. Richman, and J. Robert Stoll, and their many clients, for helping to formulate the questions and hone the analysis. It must be noted, however, that opinions expressed in this article are those of the author, and should not be attributed to Mayer, Brown & Platt or any attorneys of the firm other than the author. Back To Text

[3] Anton N. Natsis, When Lease is More, LOS ANGELES LAW., Jan. 23, 2001, at 46 (stating dot com tenants customarily are required to post credit instruments, such as letters of credit, to assure performance under their leases). Back To Text

[4] See Raleigh v. Illinois Dep't of Revenue, 530 U.S. 15, 20 (2000) (illustrating that absent contrary bankruptcy law provision, state law governs property rights); see also Butner v. United States, 440 U.S. 48, 55 (1979) (stating "[p]roperty interests are created and defined by state law;" absent compelling federal interests, bankruptcy courts should look to state law to analyze parties' respective rights.); In re Segre's Iron Works, Inc., 258 B.R. 547, 550 (Bankr. D. Conn. 2001) (stating "it is now well−settled that, except in limited instances where federal bankruptcy law specifically preempts non−bankruptcy law, the viability of claims against a bankruptcy estate is determined by reference to the applicable non−bankruptcy law under which they were created.") (emphasis in original). Back To Text

[5] See All Serv. Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus, Do Brazil, S.A., 921 F.2d 32, 34 (2d Cir. 1990) (noting generally letter of credit transactions involve three separate but related contracts); Mennen v. J.P. Morgan & Co., Inc., 91 N.Y.2d 13, 20 (N.Y. 1997) (observing letter of credit transactions typically involve three separate contractual relationships); First Commercial Bank v. Gotham Originals, Inc., 64 N.Y.2d 287, 294 (N.Y. 1985) (stating commercial letter of credit transactions involve three separate contractual relationships). Back To Text

[6] Although banks and savings and loan associations are the most frequent issuers of letters of credit, a person or organization other than a bank may be an issuer as well. See U.C.C. § 5−102 (2000) (defining "Issuer" as "a bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purposes"). Back To Text

[7] See infra II. C. Leases. Back To Text

[8] See infra II. A.1.−5, concerning several aspects of letters of credit. Back To Text

[9] See infra II. B. Reimbursed Agreements. Back To Text

[10] Hereinafter "U.C.C." All references to the U.C.C. are to the California Uniform Commercial Code, and all references to Article 9 thereof refer to the version of Article 9 effective July 1, 2001. Peter A. Alces, An Essay On Independence, Interdependence, and the Suretyship Principle, 1993 U. ILL. L. REV. 447, 450 (1993) (stating letters of credit are governed by Article 5 of the U.C.C.); Christopher Leon, Letters of Credit: A Primer, 45 MD. L. REV. 432, 438 (1986) [hereinafter Leon, Letters of Credit] (explaining letters of credit are governed by U.C.C. Article 5 if (1) letter of credit is issued by bank and requires documentary draft or documentary demand for payment; or (2) letter of credit is issued by person other than bank and requires that draft or demand for payment be accompanied by document of title; or (3) letter of credit is not within (1) or (2), but conspicuously states it is letter of credit). Back To Text

[11] Hereinafter "U.C.P." See U.C.P. art. 1 (1994) (governing letters of credit); see also Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 388 n.5 (D. Md. 1982) (noting "Uniform Customs are important as evidence of prevailing custom with regard to letters of credit"), aff'd, 704 F.2d 136 (4th Cir. 1983); Leon, Letters of Credit, supra note 8, at 439 (stating courts look to UCP in interpreting letters of credit, whether or not expressly incorporated in letter itself, to ascertain trade custom and usage). See generally W. Sur. Co. v. Bank of S. Oregon, 257 F.3d 933, 936 (9th Cir. 2001) (stating U.C.P. governs letters of credit); Henry Gabriel, Symposium, The Revision of the Uniform Commercial Code − How Successful Has it Been, 52 HASTING L.J. 653, 656 (2001) (recognizing U.C.P. governs substantial amount of letters of credit). Back To Text

[12] Hereinafter "ISP98." While the U.C.P. provides rules with respect to documentary letters of credit, ISP98 provides separate additional rules for standby letters of credit. See Byrne, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES, 309 (The Institute of International Banking Law & Practice, Inc.) (1998). ISP98 supplements applicable law to the extent not prohibited by such law, and supersedes conflicting provisions in any other rules of practice to which a standby letter of credit is also subject. Id. at 9−11; ISP98 Rule 1.02. Back To Text

[13] A "certificate of deposit" is a general deposit under which the bank agrees to repay the depositor the amount of the deposit after an agreed period of time at a specified rate of interest. Although the depositor retains the right to withdraw his deposit prior to the expiration of the time period, such a withdrawal will result in an interest penalty. See generally Drabkin v. Capital Bank, N.A. (In re Latin Inv. Corp.), 156 B.R. 102, 105 (Bankr. D.D.C. 1993) (defining certificate of deposit as writing constituting acknowledgement by bank of receipt of money and engagement to repay); Nat'l Union Fire Ins. Co. v. Proskauer, 634 N.Y.S.2d 609, 616 (1994) (defining certificate of deposit as written acknowledgement by bank of receipt of money and engagement to repay). Back To Text

[14] See U.C.C. § 5−103(d) (2000) (stating rights and obligations of issuer to beneficiary of letter of credit are independent of "contract or arrangement out of which the letter of credit arises"); U.C.P. Art. 3a. (1994) (stating "[c]redits by their nature, are separate transactions from the sales or other contract(s) on which they may be based...."). Back To Text

[15] A landlord may only draw up to the amount allowable in the lease, as agreed by the parties, and only upon the prior occurrence of events specified in the lease. Furthermore, remedies also may be subject to applicable state landlord−tenant laws. See infra notes 77−78 and accompanying text. Back To Text

[16] For example, a landlord may be required to remit amounts drawn in excess of existing defaults, or when a draw was wrongfully made. Back To Text

[17] See U.C.C. § 5−109(b) (2000) (allowing courts to enjoin issuer of letter of credit from honoring same if claim of fraud or misrepresentation is made by the applicant, provided adversely affected party is adequately protected in case such relief is granted, such fraud was committed upon the applicant or issuer or in the documents, such relief is in accordance with state law, and it is more likely than not that the applicant will prevail on claim). Back To Text

[18] Letter of credit terms and conditions must be strictly complied with in order for a beneficiary to draw thereunder. Most courts apply the "strict compliance" standard, which leaves no room for documents that are almost the same or which will do just as well. However, it should be noted that some courts have held that a beneficiary's "reasonable" or "substantial" performance of letter of credit's formal requirements will do. See Ins. Co. of N. Am. v. Heritage Bank, N.A., 595 F.2d 171, 175 (3d Cir. 1979) (holding under rule of strict compliance, insurance company not entitled to recover against bank for payment on bond, because insurance company did not comply with terms of bank's letter of credit); see also Consol. Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 390−91 (D. Md. 1982) (contending that presentment of draft after expiration date of letter of credit could be excused because of delay in mail; court disagreed with plaintiff and held letter of credit required strict compliance with expiration date). But see Crocker Commercial Serv. v. Countryside Bank, 538 F. Supp 1360, 1362 (N.D. Ill. 1981) (summary judgment for plaintiff because plaintiff reasonably complied with letter of credit and defendant waived objections to demand for payment by not objecting to demand in timely manner.). Back To Text

[19] See infra note 30 and accompanying text. Back To Text

[20] See Slamans v. First Nat'l Bank & Trust Co. of Okmulgee (In re Slamans), 69 F.3d 468, 474 (10th Cir. 1995) (remarking issuer must pay on proper demand even though beneficiary may have breached its contract with account party) (citing White & Summers, Uniform Commercial Code § 19−2 at 8 (3d ed. 1988)); see also U.C.C.§ 5−103(d) (2000) (providing "[r]ights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary"); U.C.P. Art. 3a. (1994) (providing "[c]redits by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit."). Back To Text

[21] See e.g., Sabratek Corp. v. Lasalle Bank, N.A. (In re Sabratek Corp.), 257 B.R. 732, 735 (Bankr. D. Del. 2000) (noting state action between two non−debtor parties did not involve property of bankruptcy estate, because letter of credit and proceeds were not property of debtor's estate under 11 U.S.C. § 541); N. Shore v. Am. Nat'l Bank (In re N. Shore & Cent. Ill. Freight Co.), 30 B.R. 377, 379 (Bankr. N.D. Ill. 1983) (holding beneficiary entitled to draw upon letter of credit; not property of debtor's bankruptcy estate, despite bankrupt status of debtor); Leisure Dynamics, Inc. v. Cont'l Illinois Nat'l Bank & Trust Co. of Chicago (In re Leisure Dynamics, Inc.), 33 B.R. 171, 172 (Bankr. D. Minn. 1983) (holding letter of credit not property of bankruptcy estate). But see In re Destron, Inc., 40 B.R. 927, 929 (Bankr. N.D. III. 1984) (ruling landlord lost right to proceeds of letter of credit where lease provided for letter of credit "in lieu of a security deposit," and landlord, for reasons not addressed in opinion, converted letter of credit into a certificate of deposit that landlord held in trust for the debtor). Back To Text

[22] See Kellogg v. Blue Quail Energy, Inc. (In re Compton), 831 F.2d 586, 589 (5th Cir. 1987) (stating "[i]t is well established that a letter of credit and the proceeds therefrom are not property of the debtor's estate under 11 U.S.C. § 514"); In re W.L. Mead, Inc., 42 B.R. 57, 60 (Bankr. N.D. Ohio 1984) (holding letter of credit sums are not part of bankruptcy estate); see also In re M.J. Sales & Distrib. Co., 25 B.R. 608, 616 (Bankr. S.D.N.Y. 1982) (granting plaintiff's alternative request for order annulling and vacating stay restraining third−party defendant from honoring letter of credit because it represented property of bank, not bankruptcy estate). Back To Text

[23] See 11 U.S.C. § 362(a) (1994) (providing for automatic stay, upon filing of bankruptcy petition, of any actions against the debtor or enforcement of judgments obtained prior to filing, thus in effect "freezing" debtor's estate). Except as otherwise indicated, all section references herein pertain to sections of the United States Bankruptcy Code, 11 U.S.C. § 101(1994) et seq. Back To Text

[24] See In re Marine Distrib., Inc., 522 F.2d 791, 795 (9th Cir. 1975) (holding bankruptcy court has no summary jurisdiction over letters of credit procured by debtor prior to commencing its bankruptcy proceeding); Guy C. Long, Inc. v. Dependable Ins. Co. (In re Guy C. Long, Inc.), 74 B.R. 939, 943−44 (Bankr. E.D. Pa. 1987) (citing extensive list of cases in support of proposition); Sawyer v. E.A. Walio Constr. Co. (In re Pine Tree Elec. Co.), 34 B.R. 199, 201 (Bankr. D. Me. 1983) (concluding letter of credit and its proceeds are not property of estate and not subject to

automatic stay). As discussed infra note 38, however, state law and 11 U.S.C. § 105 may provide separate grounds to support injunction, at least temporarily, of a draw. Back To Text

[25] In re Compton, 831 F.2d at 590; see also In re Guy C. Long, Inc., 74 B.R. at 943 (stating relationship between bank and beneficiary is independent of any other agreements); In re L.B.G. Prop., Inc., 33 B.R. 196, 197 (Bankr. S.D. Fla. 1983) (holding letter of credit is not property of bankruptcy estate). Back To Text

[26] See First Fid. Bank, N.A. v. Prime Motors Inns, Inc. (In re Prime Motor Inns, Inc.), 130 B.R. 610, 613 (S.D. Fla. 1991) (declining to enjoin draw under letter of credit based on provision of indentures between bondholders and indenture trustee under which debtor's filing of voluntary chapter 11 petitions constituted grounds for draw). The district court emphasized that the letters of credit "were contracts separate and independent from the indentures between the Indenture Trustee and the Authorities and the reimbursement agreements between Prime and the issuing banks . . . [and that] even if the Debtors were correct in their assertion that they should be considered parties to the indenture," they could not possibly be found to be parties to the letters of credit. Id. at 613−14. The Court ruled that "[t]he Bankruptcy Court is not empowered to interfere with a contract between non−debtors because it perceives that carrying out the contract could adversely affect the estate." Id. at 614; see also 28 U.S.C. § 1334 (1994) (conferring jurisdiction only with respect to contracts between debtors, and not over contracts between third parties); In re Zenith Lab., Inc., 104 B.R. 667, 673 (Bankr. D. N.J. 1989) (holding "a bankruptcy trustee or a debtor in possession is not entitled to enjoin a post−petition payment of funds under a letter of credit" between third parties). Back To Text

[27] See In re Metrobility Optical Sys., Inc., 2001 WL 1301750, at *3 (Bankr. D.N.H. Oct. 3, 2001) (enjoining landlord's attempts to draw on letter of credit where debtor was current on all rent payments and other obligations under lease, lease permitted draw down of entire amount of letter of credit only upon lessor's termination of lease for default, or upon tenant's failure to renew letter of credit, and "default" was triggered by unenforceable ipso facto clause in lease upon debtor's filing of bankruptcy petition). Back To Text

[28] See 11 U.S.C. § 365(e)(1) (1994) (providing default arising from filing of bankruptcy petition does not affect trustee's rights); see also Queens Blvd. Wine & Liquor Corp. v. Blum, 503 F.2d 202, 206 (2d Cir. 1974) ("hold[ing] a lease termination provision to be unenforceable when compelling equitable and policy considerations so require."); Chera v. 991 Boulevard Realty Corp. (In re Nat'l Shoes, Inc.), 20 B.R. 55, 56−57 (Bankr. S.D.N.Y. 1982) (holding express termination covenant based on bankruptcy of either party unenforceable); In re Lafayette Radio Elec. Corp., 7 B.R. 189, 191 (Bankr. E.D.N.Y. 1980) (stating no ipso facto, or bankruptcy, clause may empower landlord to terminate lease upon tenant's filing petition in bankruptcy). Back To Text

[29] In re Metrobility Optical Sys., Inc., 2001 WL 1301750, at *3; In re Farm Fresh Supermkt. of Maryland, Inc., 257 B.R. 770, 772 (Bankr. D. Md. 2001) (permitting draw down of payments by landlord from letter of credit where pre−petition demand for unpaid rent had been made, and letter of credit payments were authorized for other non−monetary defaults); In re Del. River Stevedores, Inc., 129 B.R. 38, 40 (Bankr. E.D. Pa. 1991) (noting court took comfort in creditor's allegation that debtor's bankruptcy was not sole reason for its draw under letter of credit). Back To Text

[30] See e.g. FRIEDMAN, 1 CALIFORNIA PRACTICE GUIDE; Landlord−Tenant, at ch. 2B−7−70, 2B−100 (The Rutter Group 2000) (describing various elements of rental agreements and parties' obligations thereunder). Back To Text

[31] See A.J. Lane & Co. v. The BSC Group (In re A.J. Lane & Co., Inc.), 115 B.R. 738, 741 (Bankr. D. Mass. 1990) (refusing specifically to enforce debtor's obligation to sign documents required for payment under letter of credit; creditor was left with unsecured claim in bankruptcy case); see also Sisalcords Do Brazil, Ltd. v. Fiacao Brazileira de Sisal, S.A., 450 F.2d 419, 422 (5th Cir. 1971) (holding no liability until conditions of obligation have been met and court cannot order conditions met); Far E. Textile v. City Nat'l Bank & Trust, 430 F. Supp 193, 195 (S.D. Ohio 1977) (stating beneficiary's demand for payment must conform with terms of letter of credit). Back To Text

[32] 11 U.S.C. § 362(a) (1994) (providing, with exceptions, that filing of bankruptcy petition operates as stay of any act against debtor or property of estate); see also In re Connecticut Pizza, Inc., 193 B.R. 217, 226 (Bankr. D. Md. 1996)

(noting filing of petition under § 362 "operates as a stay against various actions against property of the estate"); In re Nat'l Cattle Congress, Inc., 179 B.R. 588, 595 (Bankr. N.D. Iowa 1995) (observing § 362(a) broadly "applies to any act by any entity to obtain possession of property or exercise control over property of the state."). Back To Text

[33] See Twist Cap, Inc. v. S.E. Bank of Tamps (In re Twist Cap, Inc.), 1 B.R. 284, 286 (Bankr. M.D. Fla. 1979) (temporarily enjoining bank from honoring letters of credit); see also In re Pine Tree Elec. Co., Inc., 16 B.R. 105, 108 (Bankr. D. Me. 1981) (finding sufficient grounds to grant preliminary injunction to prevent bank from honoring letter of credit). But see In re Page, 18 B.R. 713, 715 (Bankr. D.D.C. 1982) (finding neither letter of credit nor its proceeds are property of estate and, therefore, that preliminary injunction was improperly granted). Back To Text

[34] 1 B.R. 284 (Bankr. M.D. Fla. 1979). See generally Howard N. Gorney, Enjoining Payment of Letters of Credit Under the Bankruptcy Code: New Concerns for Issuers and Beneficiaries, 66 AM. BANKR. L.J. 333 (1992) (arguing In re Twist Cap court failed to recognize significance of "independence principle" to letter of credit law); Gerald T. McLaughlin, Transfers in Bankruptcy, 50 FORDHAM L. REV. 1033, 1034−36 (1982) (discussing impact of In re Twist Cap on analysis of letter of credit payments as preferential payments). Back To Text

[35] See In re Twist, 1 B.R. at 285. Back To Text

[36] See id. Back To Text

[37] See id. Back To Text

[38] See Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1354 (2d Cir. 1990) (stating draw on letter of credit converted bank from unsecured lender to super−secured lender). Back To Text

[39] See First Fid. Bank, N.A. v. Prime Motors Inns, Inc. (In re Prime Motor Inns, Inc.), 130 B.R. 610, 613 (S.D. Fla. 1991) (finding letter of credit and proceeds not part of debtor's estate and trustee cannot enjoin post−petition payment of letter of credit because not a transfer of debtor's property); see also Official Comm. of Unsecured Creditors of Baja Boats, Inc. v. N. Life Ins. Co. (In re Baja Boats, Inc.), 203 B.R. 71, 74 (Bankr. N.D. Ohio 1996) (stating "[a] trustee cannot enjoin the post−petition payment of a letter of credit because such a payment is not a transfer of the debtor's property"). See generally 28 U.S.C. § 1334 (conferring jurisdiction only in regard to contracts or affairs of debtors). Back To Text

[40] See U.C.C. § 5−109 (1998) (permitting account party to bring suit in any state or federal court with jurisdiction, to enjoin issuer from honoring presentation where documents are forged or materially fraudulent, or where honoring presentation would facilitate material fraud on issuer or account party). See, e.g., Wysko Inv. Co. v. Great Am. Bank, 131 B.R. 146, 147−48 (D. Az. 1991) (issuing injunction under 11 U.S.C. § 105 upon finding "unusual circumstances," where debtor wanted to give creditor certificate of deposit in place of letter of credit and court found that "an injunction of the letter of credit was essential for reorganization and the reorganization hinged upon the injunction"); compare In re Del. River Stevedores, Inc., 129 B.R. 38, 44 (Bankr. E.D. Pa. 1991) (granting two−week injunction under 11 U.S.C. § 105 to stay draw under letter of credit in expectation that debtor would seek and obtain court authority directly to pay pre−petition obligations that otherwise would be paid through post−petition draws under letter of credit); with In re Metrobility Optical Sys., Inc., 2001 WL 1301750, at *3 (Bankr. D.N.H. Oct. 3, 2001) (finding no special circumstances but temporarily enjoined draw where, absent enforcement of ipso facto clause, there was no basis for draw under letter of credit). Back To Text

[41] This generally would be brought as a breach of contract action under applicable state law. Back To Text

[42] See Am. Bank of Martin County v. Leasing Serv. Corp. (In re Air Conditioning, Inc.), 845 F.2d 293, 296 (11th Cir. 1988) (citing In re Compton with approval); Kellogg v. Blue Quail Energy, Inc. (In re Compton), 831 F.2d 586, 590 (5th Cir. 1987) (holding transfer of debtor's property has occurred under 11 U.S.C. § 547 when debtor pledges assets to secure letter of credit). Section 547(b) empowers a debtor in bankruptcy (or its trustee) to avoid any transfer of an interest of the debtor in property that was made within 90 days before the filing of the debtor's bankruptcy case (the "petition date") to or for the benefit of a creditor, for or on account of a debt of the debtor that arose before the date of

the transfer, where the debtor was insolvent when the transfer was made, and the transfer enabled the creditor to receive more on account of that antecedent debt than it otherwise would have received if the debtor had filed a chapter 7 case on the petition date. Where the transfer is made to or for the benefit of a creditor that is an insider of the debtor, the preference period is one year, rather than 90 days. Pre−petition transfers on account of fully secured debt generally are not avoidable as preferences under § 547. For purposes of § 547, "a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." 11 U.S.C. § 547(e)(1)(B). Additionally, where perfection occurs more than 10 days after the transfer is made, a transfer is deemed made at the time it is perfected. Id. at § 547(e)(2). However, in the case of purchase money financing, lien perfection does not constitute an avoidable transfer as long as the purchase money lender perfects its lien within 20 days after the debtor receives possession of the purchased property. Id. at § 547(c)(3). In any event, a transfer is not made until the debtor acquires rights in the transferred property. Id. at § 547(e)(3). Additionally, § 547 does not permit avoidance of certain transfers made within the 90−day preference period, including a transfer given as part of a contemporaneous exchange for new value, a payment in the ordinary course of the debtor's business, a lien created and perfected to secure a purchase money loan made with respect to the encumbered property, or a transfer that was followed, before the petition date, by the creditor's extension of credit to the debtor in an amount greater than such transfer. Id. at § 547(c). Nor does § 547 permit avoidance of liens on payment rights acquired by the debtor during the preference period, except to the extent that such new liens improve the creditor's secured position during the preference period. Back To Text

[43] See In re Compton, 831 F.2d at 590 (stating facts). Back To Text

[44] See id. (explaining debtor granted increased security interest in return for letter of credit for the benefit of beneficiary). Back To Text

[45] See id. at 594. The transfer was not an avoidable preference as against the issuer because the issuer gave new value by issuing letter of credit, in a contemporaneous exchange. Back To Text

[46] Id. at 594−95 (stating holding). Back To Text

[47] See 11 U.S.C. § 547(c)(i) (1994) (rendering unavoidable any transfer made in contemporaneous exchange for new value). Back To Text

[48] See U.C.C. § 5−112(a) (2000) (stating "unless a letter of credit provides that it is transferable, the right of a beneficiary to draw or otherwise demand performance under a letter of credit may not be transferred"); U.C.P. Art. 48(b) (1994) (stating "[a] Credit can be transferred only if it is expressly designated as 'transferable' by the Issuing Bank. Terms such as 'divisible,' 'fractionable,' 'assignable,' and 'transmissible' do not render the Credit transferable. If such terms are used they shall be disregarded"); see also James G. Barnes and James E. Byrne, Revision of U.C.C. Article 5, 50 BUS. LAW, 1449, 1458 (1995) (discussing codification in U.C.C § 5−112 of principle of non−transferability of letter of credit unless expressly provided); Katherine A. Barski, Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits, 41 LOY. L. REV. 735, 755−56 (1996) [hereinafter Barski, Letters of Credit] (discussing codification in U.C.C and U.C.P. of principle of non−transferability of letter of credit unless expressly provided). Back To Text

[49] See U.C.C. § 5−104 (2000) (stating "[a] letter of credit . . ., transfer, . . . may be issued in any form that is a record and is authenticated . . . in accordance with the agreement of the parties or the standard practice [of financial institutions that regularly issue letters of credit]"); see also Vest v. Pilot Point Nat'l Bank, 996 S.W.2d 9, 15 (Tex. App. 1999) (discussing how neither U.C.C. nor U.C.P. requires issuer to verify that demand for payment is mirror image of letter of credit); Barski, supra note 46, at 743 (discussing how U.C.C. § 5−104 does not "specify any particular medium in which the letter of credit must be established or communicated . . . [it] recognizes that many letter of credit transactions are now conducted by electronic means"). Back To Text

[50] It is not desirable for the landlord's signature to be necessary at all times, as the mortgage lender may not be able to compel the landlord's execution of documents necessary to obtain a draw under the letter of credit if the landlord is a debtor in a bankruptcy case. See A.J. Lane & Co. v. BSC Group (In re A.J. Lane & Co.), 115 B.R. 738, 741 (Bankr.

D. Mass. 1990) (holding Debtor's obligation to sign both judgment certification and agreement for judgment was transformed through bankruptcy filing from one which may have been specifically enforceable to monetary claim which is both allowable and dischargeable in chapter 11 proceeding); see also 11 U.S.C. § 101(5) (1994) (defining "claim" as "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or . . . right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured"); Cofield v. Guar. First Trust Co. (In re Cofield), 138 B.R. 341, 344 (Bankr. D. Mass. 1992) (holding "[letter of credit issuer] had at least a contingent claim for reimbursement against [debtor] until such time as it [the issuer] paid [obligee] under the letter of credit and its [issuer's] claim became fixed and no longer contingent"). Additionally, after the commencement of the landlord's bankruptcy case, the letter of credit likely would constitute property of the landlord's bankruptcy estate and the mortgage lender would be stayed from drawing under the letter of credit. The risks of this dual beneficiary structure have not been developed in bankruptcy caselaw, but could be substantial and complex. Back To Text

[51] See U.C.C. § 5−114(b) (2000) (stating beneficiary may assign right to part or all of proceeds of a letter of credit and may do so before presentation as present assignment of its right to receive proceeds contingent upon its compliance with terms and conditions of letter of credit); U.C.P. Art. 49 (1994) (stating that fact Credit is not specifically transferable does not affect the Beneficiary's right to assign any proceeds to which he may be, or may become, entitled). See generally Dellas W. Lee, Letters of Credit: What does Revised Article 5 Have to Offer to Issuers, Applicants, and Beneficiaries?, 101 COM. L.J. 234, 242 (1996) [hereinafter Lee, Letters of Credit] (discussing assignment of letter of credit rights). Back To Text

[52] See U.C.C. § 9−102(a)(51) (2000) (defining 'Letter−of−credit right'). See generally Louis F. Del Duca et al.., Simplification in Drafting: The Uniform Commercial Code Article 9 Experience, 74 CHI.−KENT L. REV. 1309, 1310 (1999) (discussing emphasis of "plain English" in Article 9 revisions); Harry C. Sigman & Edwin E. Smith, Revised U.C.C. Article 9's Transition Rules: Insuring a Soft Landing, 55 BUS. LAW. 1065, 1068 (2000) (discussing changes in wording and additions to revised Article 9). Back To Text

[53] See U.C.C. § 5−114(e) (2000) (stating "[r]ights of a transferee beneficiary or nominated person are independent of the beneficiary's assignment of the proceeds of a letter of credit and are superior to the assignee's right to the proceeds"). See generally First Commercial Bank v. Gotham Originals Inc., 486 N.Y.S.2d 715, 719 (N.Y. 1985) (discussing issuer's obligation to pay contingent upon presentation of drafts and documents specified in letter of credit); Regent Corp., U.S.A. v. Azmat Bangladesh, Ltd., 686 N.Y.S.2d 24, 29 (N.Y. App. Div. 1999) (discussing defenses available in U.C.C. § 5−114 to a presenter of drafts under letter of credit). Back To Text

[54] See U.C.C. § 9−329(1) (2000) (stating "[a] security interest held by a secured party having control of the letter−of−credit right under § 9−107 has priority to the extent of its control over a conflicting security interest held by a secured party that does not have control"). Back To Text

[55] See U.C.C. § 9−107 (2000) (stating "[a] secured party has control of a letter−of−credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under § 5−114(c) or otherwise applicable law or practice"). Back To Text

[56] See U.C.C. § 5−114(d) (2000) (stating "[a]n issuer or nominated person has no obligation to give or withhold its consent to an assignment of proceeds of a letter of credit, but consent may not be unreasonably withheld if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honor"). Back To Text

[57] Assuming, as often is the case, that the mortgage lender has possession of the letter of credit, and that draws are conditioned on presentation of the original letter of credit, the mortgage lender nonetheless will have to participate in each draw. Back To Text

[58] See 11 U.S.C. § 547(b) (1994) (stating when and under what conditions transfer can be avoided). Additionally, effectuation of the transfer after commencement of the landlord's bankruptcy case would violate the automatic stay imposed by 11 U.S.C. § 362(a) and would be void. See generally Lawrence Ponoroff, Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time, 1993 WIS. L. REV 1439, 1449−50 (1993) (arguing there should be objective determination of when preference is made). Back To Text

[59] 11 U.S.C. § 547(b)(4) (1994) (stating "[e]xcept as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property . . . made . . .on or within 90 days before the date of the filing of the petition; or . . . between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider"). This element alone is not enough to establish that an avoidable preference has occurred. Rather, 11 U.S.C. § 547(b) also requires the showing of four additional elements, and all might not be present in any given case. See 11 U.S.C. § 547(b) (stating five elements). For example, under § 547(b)(5), if the value of all of the mortgage lender's collateral, at the time it received the transfer of the letter of credit, exclusive of the letter of credit, exceeded the amount of the mortgage lender's claim against the landlord, then the transfer would not enable the mortgage lender to receive more than it would have received in the landlord's chapter 7 case absent such transfer. In such a case, the transfer of the letter of credit would not be an avoidable preference. See generally Richard T. Thomson, Effective date of Transfers by Check Under § 547(c)(4) of the Bankruptcy Code: In Support of the Delivery Rule, 95 COM. L.J. 217, 218 (1990) (discussing when transfer by check occurs for purposes of Bankruptcy Code § 547); Barry L. Zaretsky, Avoidance of Preferential Transfers of Exempt Property, 215 N.Y.L.J. 12 (1995) (discussing avoidance of preferential transfers). Back To Text

[60] A trustee cannot avoid a transfer that is a contemporaneous exchange for new value. See 11 U.S.C. § 547(c)(1) (1994) (stating "[t]he trustee may not avoid under this section a transfer−−(1) to the extent that such transfer was−−(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange"). See generally Charles E. Reynolds, Maginot Line Defenses to a Preference Action? 11 U.S.C. 547(c)(2) & (c)(4), 21 U. RICH. L. REV. 317, 318 (1987) (discussing ordinary course of business and subsequent advance defenses to preference actions); David W. Skeen, Liens and Liquidation: Preferences, Strong Arm Clause, Fraudulent Transfers, Equitable Subordination, Priorities and Other Limitations on Liens Claims, 59 TUL. L. REV. 1401, 1402 (1985) (discussing avoidance powers of trustee). Back To Text

[61] A delay in perfection more than ten days after the effective date of mortgage loan agreement (twenty days, if it is a purchase money loan relating to the landlord's property) may render the perfection an avoidable transfer. See 11 U.S.C. § 547(e)(2)(B) (1994) (stating "a transfer is made . . . at the time such transfer is perfected, if such transfer is perfected after such 10 days"); 11 U.S.C. § 547(c)(3) (1994). Section 547(c)(3) provides, in pertinent part:

The trustee may not avoid under this section a transfer . . . that creates a security interest in property acquired by the debtor . . . to the extent such security interest secures new value that was . . .(i) given at or after the signing of a security agreement that contains a description of such property as collateral; (ii) given by or on behalf of the secured party under such agreement; (iii) given to enable the debtor to acquire such property; and (iv) in fact used by the debtor to acquire such property.

Id. Moreover, perfection of the security interest after commencement of the landlord's bankruptcy case generally would violate the automatic stay and be void or voidable. Compare Gruntz v. County of Los Angeles (In re Gruntz), 202 F.3d 1074, 1082 (9th Cir. 2000) (stating acts in violation of automatic stay are void); and LaBarge v. Vierkant (In re Vierkant), 240 B.R. 317, 325 (B.A.P. 8th Cir. Minn. 1999) (stating same), with Soares v. Brockton Credit Union (In re Soares), 107 F.3d 969, 978 (1st Cir. 1997) (stating acts in violation of automatic stay are voidable); Easley v. Pettibone Michigan Corp., 990 F.2d 905, 911 (6th Cir. 1993) (stating same). Back To Text

[62] See U.C.C. § 9−329 (2000) (establishing rules governing priority among conflicting security interests in the same letter of credit right); U.C.C. § 9−314 (2000) (describing methods of perfecting security interests in investment property, deposit accounts, letter of credit rights, or electronic chattel paper); see also In re Security Servs., 132 B.R. 411, 414 (W.D. Mo. 1991) (describing in detail process of transferring security interest in debtor's property to secure issuance of letter of credit). Back To Text

[63] Such perfection may be subject to avoidance in the landlord's bankruptcy case, if such a case is filed during the 90−day preference period, but prompt action increases the probability that the preference period will lapse before the landlord becomes a debtor in a bankruptcy case. Back To Text

[64] See 11 U.S.C. § 541(a) (1994) (describing property of bankruptcy estate). Back To Text

[65] See 11 U.S.C. § 363(a) (1994) (defining cash collateral, in part, as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents). See generally John C. Chobot, Enforcing the Cash Collateral Obligations of Debtors in Possession, 96 COM. L.J. 136, 138−140, 152 (1991) (discussing need for bankruptcy courts to encourage observance of cash collateral agreements); Honorable Stephen A. Strip, Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11, 21 SETON HALL L. REV. 562, 564 (1991) (discussing courts interests in modifying consensual cash collateral orders in order to satisfy needs of parties involved). Back To Text

[66] See 11 U.S.C. § 363(e) (1994) (providing upon request court shall provide protection for entities with interests in property which are, or are proposed to be used, sold, or leased by a trustee, in order to provide adequate protection for such interest); 11 U.S.C. § 361 (1994) (discussing how adequate protection may be provided when required under §§ 362, 363, or 364). See generally Elaine S. Fisher, Use, Sale or Lease of Property; Obtaining Credit; Executory Contracts. 1 BANKR. DEV. J. 240, 241 (1984) (discussing limitations of trustee when cash collateral is involved); Frederick M. Luper and Kenneth M. Richards, Valuation of Property Issues in Bankruptcy, 98 COM. L.J. 35, 37 (1993) (discussing need for courts to make decisions as to valuation of property early on in litigation because of statutory authorization of use of collateral). Back To Text

[67] See 11 U.S.C. § 363(c)(2) (1994) (listing circumstances in which trustee may use, sell or lease cash collateral). The same would be true of a traditional cash security deposit in the landlord's possession during the landlord's bankruptcy case. Id. Back To Text

[68] See 11 U.S.C. § 552 (a) (1994) (stating property acquired by estate or debtor after commencement of case is not subject to any lien resulting from any security agreement entered into by debtor before commencement of case); Chemical Bank v. United States (In re McLean Indus., Inc.), 132 B.R. 271, 283 (Bankr. S.D.N.Y. 1991) (commenting that general rule by which after−acquired property of estate is not subject to any lien as result of any security agreement entered into by debtor prior to commencement of bankruptcy is subject to limitations which allow pre−petition security agreement to extend to proceeds when security agreement and nonbankruptcy law so provide); In re Bohne, 57 B.R. 461, 463 (Bankr. D. N.D 1985) (stating any security interest given by debtor in property which is not acquired by debtor until commencement of bankruptcy case is avoided). Back To Text

[69] See Grubdy Nat'l Bank v. Stiltner, 58 B.R. 593. 594−95 (W.D. Va. 1986) (holding provisions of automatic stay apply to chapters 7, 9 and 11 equally); In re Seafarer Fiber Glass Yachts, Inc., 1 B.R. 358, 361−63 (Bankr. E.D.N.Y. 1979) (stating purpose of automatic stay in halting chaotic scramble of creditors to seize property). Back To Text

[70] See 11 U.S.C. § 552(b) (1994) (stating equities exception to general rule that pre−petition security interest in property and proceeds thereof extends to post−petition proceeds of property of the debtor acquired before the commencement of case); see also J. Chatton Farms, Inc. v. First Nat'l Bank of Chicago, 779 F.2d 1242, 1246−47 (7th Cir. 1985) (commenting that equity exception to after−acquired property rule that, if debtor gave creditor pre−petition security interest in proceeds, security interest extends to proceeds acquired after filing, is meant for case where trustee or debtor possession uses other assets of bankruptcy estate); In re Photo Promotion Assoc., Inc., 61 B.R. 936, 939 (Bankr. S.D.N.Y. 1986) (stating equity exception to statute governing post−petition effect of pre−petition security interest requires bankruptcy court to balance rights between pre−petition security interests and those of creditors of estate). At least one bankruptcy judge believes that the "expansion of the collateral base authorized by the revisions to Article 9, and the contraction of unencumbered property resulting therefrom, will likely lead to a broader use of [the 'equity exception' created by] section 552(b)." See Bufford, Hon. S., Revised UCC Article 9 and Bankruptcy: A Judicial Viewpoint, 9 NORTON BANKR. ADVISOR 1 (Aug. 2001). Judge Bufford's article contains an extensive discussion of the two lines of cases that interpret and apply the equity exception. Id. at 3−4. Back To Text

[71] See 11 U.S.C. § 547(c)(5) (1994) (stating "trustee may not avoid a transfer that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date for the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt"); Sloan v. Zions First Nat'l Bank, N.A. (In re Castletons, Inc.), 990 F.2d 551, 556 (10th Cir. 1993) (declaring purpose of 11 U.S.C. § 547(c)(5) is to protect secured creditor from preference liability resulting from mere market fluctuations in value of debtor's accounts or inventory during 90 day period but secured creditor may not improve its position at expense of other creditors); Smith v. Assoc. Commercial Corp. (In re Clarke Pipe & Supply Co.), 870 F.2d 1022, 1025−26 (5th Cir. 1989) (applying two point net improvement test in situation in which only issue was value of inventory). Back To Text

[72] See supra note 29 (citing In re A.J. Lane & Co., Inc.). Back To Text

[73] In order to comply with the requirements of derivative markets, many mortgage lenders require borrowers to be structured as single purpose, bankruptcy−remote entities. See generally STANDARD & POOR'S STRUCTURED FINANCE RATINGS, REAL ESTATE FINANCE: LEGAL AND STRUCTURED ISSUES IN COMMERCIAL MORTGAGE SECURITIES, 26 (Standard & Poor eds.) (1995). Back To Text

[74] See generally Evans v. Midland Enter., Inc., 754 F.Supp 91, 93 (M.D. La. 1990) (describing reimbursement agreement); Bank of Tokyo Trust Co. v. Urban Food Malls, 229 A.D. 2d 14, 25 (N.Y. App. Div. 1996) (stating default under terms of reimbursement agreement occurs in instance where defendant fails to pay when installment or principal or any sum is due); Monte M. Brem, Western Security Bank v. Beverly Hills Business Bank: The Vanishing Utility of Letters of Credit In Real Estate Transactions, 31 SAN DIEGO L.REV. 775, 776 (1994) (stating reimbursement contract obligates the customer/borrower to the issuer). Back To Text

[75] See U.C.C. § 5−108(a) (2000) (stating "[e]xcept as otherwise provided in section 5−109, an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply within terms and conditions of letter of credit. Except as otherwise provided in section 5−113 and unless otherwise agreed with applicant, issuer shall dishonor presentation that does not appear so to comply."). See generally Gillman v. Chase Manhattan Bank, 73 N.Y.2d 1, 12 (1988) (concluding obligation of issuer of letter of credit to honor properly presented draft is independent of any underlying contractual agreement between account party and beneficiary); New Braunfels Nat'l Bank v. Odiorne, 780 S.W.2d 313, 318 (Tex. App. 1989) (concluding strict compliance does not demand oppressive perfectionism). Back To Text

[76] This is precisely what happened in Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (In re Powerine), 59 F.3d 969, 972 (9th Cir. 1995) (reciting facts of case). Back To Text

[77] In re Powerine, 59 F.3d at 973 (demonstrating importance of monitoring tenant accounts and importance of assuring that all of beneficiary's rights are fully protected before undrawn letter of credit is permitted to expire). Back To Text

[78] See Twist Cap, Inc. v. S.W. Bank of Tampa (In re Twist Cap, Inc.), 1 B.R. 284, 285 (Bankr. M.D. Fla. 1979) (opining payment of unsecured claims by draws on letters of credit would give preferential treatment to unsecured creditors, which is contrary to goal of Bankruptcy Code). Back To Text

[79] See generally MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 663 (10th ed. 1997) (defining lease as "a contract by which one conveys real estate, equipment, or facilities for a specified term and for a specified rent; also the act of such conveyance or the term for which it is made"). Back To Text

[80] For example, Cal. Civ. Code § 1950.7 appears to limit the use of security deposits to reimbursement of unpaid rent as of lease termination and repair and restoration of premises, and to require repayment of any unapplied balance to the tenant without first offsetting prospective damages for lost rent. See Cal. Civ. Code § 1950.7 (1994) (discussing security for performance of rental agreement for other than residential property); Public Employees' Ret. Sys. v. Winston, 209 Cal. App. 3d 205, 211 (1989) (discussing lessor's right to recover amount of rent owed plus interest); Michael St. James, Landlord Beware: Will a Security Deposit Survive a Bankruptcy, 26 CAL. BANKR. J. 44 (2001);

see also Norris, Tulipmania Redux, 19 CAL. REAL PROP. J. 27, 29−30 (2001) (discussing application of Cal. Civ. Code § 1950.7). As of the date of this article, no reported California bankruptcy cases have compelled a landlord to turn over a security deposit instead of retaining it in recoupment of a portion of the landlord's entire allowed claim against the debtor tenant, but the recent publication of the California Bankruptcy Journal article may precipitate tenant debtor actions for turnover of security deposits. Landlords may want to consider obtaining waivers of Cal. Civ. Code § 1950.7 or similar provisions in other states at the time leases are executed (or by subsequent amendment). See id. at 29−30. Additionally, landlords may avoid the effect of such provisions by providing that a letter of credit is taken in lieu of a security deposit, to support all obligations of the tenant under the lease, and is available in full to satisfy all damages resulting from the tenant's failure to pay or perform. Id. Back To Text

[81] See 11 U.S.C. § 541(a) (1994) (describing property of estate). Back To Text

[82] See 11 U.S.C. § 362(a)(3) (1994) (stating stay is operative upon filing of bankruptcy petition with respect to any act to obtain possession of property of estate or of property from estate or to exercise control over property of estate); Loethen Oil Co. v. Hen House Interstate, Inc. (In re Hen House Interstate, Inc.), 136 B.R. 220, 223 (Bankr. E.D. Mo. 1992) (concluding chapter 11 debtor properly separated additional rent owed to lessor into pre−petition and post−petition compartments thereby rendering creditors' post−petition attempts to collect rent payments through offset for three month period violation of automatic stay); In re Morningstar Enter., Inc., 128 B.R. 102, 104 (Bankr. E.D. Pa. 1991) (stating landlord violated automatic stay by unilaterally setting off part of debtors security deposit against pre−petition rent arrearages). Notably, any right of recoupment that the landlord may have should not be affected by the automatic stay. 5 KING, COLLIER ON BANKRUPTCY ¶ 553.10, n. 8 and accompanying text (15th ed. 2001) (observing "better rule" is recoupment rights are not affected by automatic stay). Back To Text

[83] If it is denominated a security deposit, the landlord could be at greater risk that a bankruptcy court would consider arguments that the parties intended the letter of credit to be treated like any other security deposit in the event of the tenant's bankruptcy, and thus be subject to the § 502(b)(6) cap. We have found only one case where the court held that the rule that a security deposit must be applied to payment of the landlord's claim as capped by § 502(b)(6) (see discussion of cap, infra II. D. 5 Landlord's Damages Upon Rejection) is equally applicable where the security deposit is in the form of a letter of credit. See In re PPI Enter. (U.S.), Inc., 228 B.R. 339, 350 (Bankr. D. Del. 1998) (holding letter of credit proceeds drawn pre−petition were security deposit that had to be applied toward payment of capped claim). However, the PPI Court did not address, and the landlord apparently did not argue, whether a letter of credit should or could be treated differently than a traditional security deposit. Id. Back To Text

[84] The loan documents between a mortgage lender and the landlord also should require that each such letter of credit be acceptable and transferable to the mortgage lender. See generally Official Comm. of Unsecured Creditors of Baja Boats v. N. Life Ins. Co., 203 B.R. 71, 74 (Bankr. N.D. Ohio 1996) (stating letters of credit are three part transactions where debtor obtains letter of credit from lending institution which names creditor of debtor as beneficiary); Thomasson v. Amsouth Bank, 59 B.R. 997, 1004 at n.2 (N.D. Ala. 1986) (defining letter of credit as "engagement by a bank or other person made at the request of a customer...that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit."); RICHARD T. NASSBERG, THE LENDER'S HANDBOOK 39 (American Law Institute 1986) (discussing letter of credit is valuable to beneficiary because it assures payment regardless of financial or legal incapacity of account party who procured issuance of letter of credit). Back To Text

[85] See 11 U.S.C. § 365(f) (1994) (describing when trustee may assign contract or lease and conditioning assignment on trustee's prior or concurrent assumption of contract or lease in compliance with provisions of § 365(a) or (b).) Back To Text

[86] See 11 U.S.C. § 1141(b) (1994) (stating "except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor"); see also In re Gillis, 92 B.R. 461, 465 (Bankr. D. Haw. 1988) (holding lease and post−petition rents automatically become part of debtor's estate); Prince v. Clare, 62 B.R. 270, 272 (Bankr. N.D. Ill. 1986) (explaining except as otherwise provided in plan, confirmation of plan vests all property of bankruptcy estate in Debtor); In re NJB Prime Investors, 3 B.R. 553, 556 (Bankr. S.D.N.Y. 1980) (explaining purpose of revesting property). Back To Text

[87] Care should be taken to assure that the landlord's letter of credit rights are not construed as liquidated damages or any other exclusive remedy, unless that is the parties' intent. If so, the liquidated damages provision should be drafted to comply with requirements of applicable nonbankruptcy law. See, e.g., Cal. Civ. Code § 1671 (1994) (stating "a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."). See generally Telescripps Cable Co. v. Welsh, 247 Ga. App. 282, 285 (2000) (stating requirements for late fees to comply with state liquidated damages provisions); Fidelity & Casualty Co. v. Copenhaven Contracting Co., 159 Va. 126, 135 (1932) (holding construction contract's liquidated damages provisions comported with the state's "reasonable" standard). Similarly, if the landlord is permitted to draw amounts in excess of existing damages, such as upon the tenant's failure to renew the letter of credit, the lease should not require the landlord to take any action that would or could convert the letter of credit proceeds back into property of the tenant. See In re Destron, Inc., 40 B.R. 927, 929 (Bankr. N.D. III. 1984) (ruling that landlord lost right to proceeds of letter of credit where lease provided for letter of credit "in lieu of a security deposit," and landlord, for reasons not addressed in opinion, converted letter of credit into a certificate of deposit that landlord held in trust for debtor, and not as security deposit). Back To Text

[88] See Kuaerner U.S. Inc. v. Hakim Plast Co., 74 F. Supp.2d 709, 718 (E.P. Mich. 1999) (stating waiver occurs when party with all knowledge of material facts acts inconsistent with his intention to rely on his right in question); Fitzgerald v. Hubert Herman, Inc., 23 Mich. App. 716, 718 (Ct. App. Mich. 1970) (same); Strom−Johnson Constr. Corp. v. Rivervi Furniture Store, 227 Mich. 55, 68 (Mich. Sup. Ct. 1924) (stating waiver may be shown by proof of express language of agreement or inferably established by act or declaration). Back To Text

[89] See 11 U.S.C. § 365(a), (b), (d)(4), (f), (k) (1994) (providing when and on what conditions trustee may or may not assume or reject any executory contract or unexpired lease of debtor, and explaining consequences of assumption or rejection); see also Robert M. Fishman, Suggestion for the National Bankruptcy Review Commission and Congress: The Effectiveness of Rejection, 4 AM. BANKR. INST. L. REV. 512, 512 (1996) (explaining how § 365 affects commercial leases). See generally Jeffrey S. Battershall, Commercial Leases and section 365 of the Bankruptcy Code, 64 AM. BANKR. L.J. 329 (1990) [hereinafter Battershall] (explaining how § 365 affects commercial leases). Back To Text

[90] See 11 U.S.C. § 502(b)(6) (1994) (capping allowed amount of landlord's claim for lease damages that arose or are deemed to have arisen before commencement or conversion of tenant's bankruptcy case); id. at § 365(d)(3) (requiring payment of all amounts due under lease post−petition pending assumption or rejection); id. at § 365(g) (determining effective date of rejection for purposes of calculating claim amount and priority); see also Cukierman v. Uecker (In re Cuckierman), 2001 U.S. App. LEXIS 19737, at *6 (9th Cir. Sept. 7, 2001) (explaining § 365(d)(3) claims are entitled to administrative priority under § 507); Towers v. Chickering & Gregory (In re Pacific−Atlantic Trading Co.), 27 F.3d 401, 403 (9th Cir. 1994) (stating during period prior to assumption or rejection, trustee must continue to "perform all obligations of debtor" under lease). Additionally, 11 U.S.C. § 362(a) stays a landlord's enforcement of remedies against property of the bankruptcy estate during the tenant's bankruptcy case. 11 U.S.C. § 362(a) (1994). Back To Text

[91] See infra II. D.5. Landlord's Damages Upon Rejection, (discussing 11 U.S.C. § 502(b)(6) (1994 Back To Text

[92] In In re Cukierman, the debtor is required to pay loan amounts payable under the lease as part of its lease obligations, pending assumption or rejection. 2001 U.S. App. LEXIS 19737, at *5. Implicit in this is the idea that the debtor would have to pay all such loan amounts that were delinquent at the time it elected to assume the lease. If, instead, loan provisions were not so incorporated into the lease, payments of loan amounts would not be encompassed in the "cure" concept. See 11 U.S.C. § 365(b)(1) (1994) (requiring all defaults to be cured before assumption will be permitted). Back To Text

[93] 11 U.S.C. §§ 365(a), (b), (d)(4) (1944). In the Ninth Circuit, multiple extensions of the deadline may be granted so long as each motion requesting an extension is filed before the lapse of the election period. See, e.g., Willamette Waterfront, Ltd. v. Victoria Station, Inc. (In re Victoria Station, Inc.), 875 F.2d 1380, 1384−85 (9th Cir. 1989). Other courts, however, require that the court's order granting the extension actually be entered before the election period

lapses. See DeBartolo Properties Mgmt., Inc. v. Devan, 194 B.R. 46, 51−52 (D. Md. 1996) (rejecting Victoria Station analysis in favor of strict statutory construction). This deadline, and the debtor's ability to extend it, may be affected by proposed amendments to the Bankruptcy Code. As of October 2001, the proposed amendment to 11 U.S.C. § 365(d)(4) (1994) provides for an initial deadline of 120 days after the entry of the order for relief, and permits the court, for cause, to grant just one 90−day extension of the deadline. See H.R. 333, 107th Cong. 404(a) (2001) (engrossed in senate). Back To Text

[94] See In re Klein Sleep Prod., 78 F.3d 18, 28 (2d Cir. 1996) (stating after post−petition lease assumption, all obligations of debtor thereunder held post−petition administrative priority, and landlord's claims not limited by 11 U.S.C. § 502(b)(6)). Regrettably, this does not ensure payment in full of such claims if there are insufficient funds in the debtor's estate to pay all administrative claims in full (payment then would be pro rata among all such claims). See In re LPM Corp., 253 B.R. 914, 919 (Bankr. S.D. Cal. 2000) (reviewing caselaw and adopting majority view that § 365(d)(3) does not create superiority administrative claim for landlords, citing and rejecting contrary law). Accordingly, chapter 11 administrative claims would be paid pro rata from any funds remaining after chapter 7 administrative claims were paid in full. Id. Further, if such claims arise in a chapter 11 case, and that case is converted to a case under chapter 7 of the Bankruptcy Code, they will be subordinated to administrative claims incurred after the case is converted. See id. at 918; see also 11 U.S.C. § 726(b) (1994) (stating when case is converted to chapter 7, chapter 7 administrative claims have priority under § 507). Back To Text

[95] See 11 U.S.C. §§ 365(d)(4), (g) (1994) (stating if debtor does not assume or reject lease within sixty days after date of order for relief, or within any additional time given by Court, then such lease is deemed rejected and such rejection constitutes breach); see also Med. Malpractice Ins. Ass'n v. Hirsch (In re Lavigne), 114 F.3d 379, 386−87 (2d Cir. 1997) (explaining while rejection is treated as breach, it does not completely terminate contract); Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.), 19 F.3d 1077, 1082 (5th Cir. 1994) (stating rejection is treated as breach to preserve rights of party whose lease with debtor has been rejected). Back To Text

[96] See Century Indem. Co. v. NGC Settlement Trust (In re Nat. Gypsum Co.), 208 F.3d 498, 505 (5th Cir. 2000) (stating rejection of lease gives rise to claim treated similar to all other unsecured claims); In re Chateaugay Corp., 130 B.R. 162, 164 (Bankr. S.D.N.Y. 1991) (explaining rejection by debtor would affect whether landlord holds pre−petition general unsecured claim or post−petition administrative priority claim); see also In re Parkwood Realty Corp., 157 B.R. 687, 689 (Bankr. W.D. Wash. 1993) (explaining consequence of debtor's rejection of Shareholder Agreement is creditor has general unsecured claim for breach). Back To Text

[97] See First Fid. Bank, N.A. v. Prime Motor Inns, Inc. (In re Prime Motor Inns, Inc.), 130 B.R. 610, 613 (S.D. Fla. 1991) (stating § 1124 does not give bankruptcy court power to interfere with contract between non−debtors); see also Beard v. Braunstein, 914 F.2d 434, 445 (3d Cir. 1990) (finding contractual claims that arise prior to petition are non−core matters); In re Nat'l Enter., Inc., 128 B.R. 956, 960 (Bankr. D. Va. 1991) (explaining contractual claims between non−debtors that arise prior to petition do not have substantial connection to bankruptcy and therefore are non−core matters). Back To Text

[98] See In re Metrobility Optical Sys., Inc., 2001 WL 1301750, at *4 (Bankr. D.N.H. Oct. 3, 2001) (enjoining draw under letter of credit, pursuant to finding draw based only on unenforceable ipso facto provision in lease.) Back To Text

[99] See 11 U.S.C. §§ 365(a), (b)(2) (1994) (stating trustee may assume or reject any executory contract or unexpired lease of debtor even if there is breach of provision relating to insolvency of debtor, commencement of case, or appointment of or taking possession by trustee in case before commencement); see also In re Merchandise Co., 256 B.R. 755, 769 (Bankr. M.D. Tenn. 2000) (explaining debtors were free to assume lease at any time before deadline); Battershall, supra note 87, at 336 (discussing effect of § 365 on commercial leases). Back To Text

[100] Defaults arising under a contract to which the debtor is a party by virtue of the debtor's insolvency or bankruptcy generally are considered "ipso facto," are not recognized in bankruptcy, and do not need to be "cured." See 11 U.S.C. § 365(e)(1) (1994); see also In re Pak, 252 B.R. 215, 216 n.1 (Bankr. M.D. Fla. 2000) (stating "ipso facto" clauses that purport to trigger modification of debtor's interest in property upon filing of bankruptcy petition are unenforceable); In

re B. Siegel Co., 51 B.R. 159, 163−64 (Bankr. E.D. Mich. 1985) (ruling insurer was not free to cancel debtor's insurance policy, terminable at will, because of debtor's involuntary bankruptcy). Back To Text

[101] See 11 U.S.C. § 365(b)(1) (1994); see also Cannery Row Co. v. Leisure Corp. (In re Leisure Corp.), 234 B.R. 916, 922 (B.A.P. 9th Cir. 1999) (stating if debtor or trustee decides to assume unexpired lease, it must cure any defaults or provide adequate assurance it will cure); In re Ok Kwi Candles, Inc., 75 B.R. 97, 102 (Bankr. N.D. Ohio 1987) (denying motion to assume unexpired lease because motion was untimely and debtor failed to cure defaults). Back To Text

[102] See In re Valley View Shopping Ctr, L.P., 260 B.R. 10, 26 (Bankr. D. Kan. 2001) (permitting debtor to assume lease and cure pre−petition defaults by payments of delinquent amounts plus interest over period of two years); In re PRK Enter., Inc., 235 B.R. 597, 602 (Bankr. E.D.Tex. 1999) (permitting debtor to assume leases and cure defaults over a period of four months); In re Clark, 168 B.R. 280, 283 (Bankr. W.D.N.Y. 1994) (authorizing debtor to make payments over time to cure its defaults under excecutory contract assumed pursuant to § 365); In re Callahan, 158 B.R. 898, 904 (Bankr. W.D.N.Y. 1993) (explaining debtor must also pay interest when proposed cure is to be accomplished over time). Back To Text

[103] In In re Farm Fresh Supermarkets of Md., Inc. the landlord drew entire $38,000 letter of credit post−petition on account of $13,044 default for November rent. 257 B.R. 770, 771 (Bankr. D. Md. 2001). Nonetheless, debtor's trustee apparently paid $13,044 to cure the same default as a prerequisite to lease assumption. The Court held that the trustee could not obtain either the $38,000 drawn on the letter of credit or the $13,044.15 because "the proceeds of the letter were properly drawn down by Arbutus (landlord) pursuant to the terms of the lease and the letter of credit," and therefore "neither the letter of credit nor its proceeds were property of the debtor's estate." Id. at 772; see also Willis v. Celotex Corp., 978 F.2d 146, 148 (4th Cir. 1991) (holding letter of credit was not property of estate and therefore surety could draw down on letter of credit in event of debtor's default). Back To Text

[104] Such a demand is supported by § 365(l), which entitles the landlord to require "a deposit or other security" from the assignee substantially the same as the landlord would have required if the assignee were entering into a new lease with the landlord. 11 U.S.C. § 365(l) (1994); see Vermont Fed. Sav. & Loan Ass'n v. Burlington Tennis Assoc. (In re Burlington Tennis Assocs.), 34 B.R. 836, 839 (Bankr. D. Vt. 1983) (reasoning because lessor waived his right to collateralized security for rents, it was not necessary for debtor to reopen letter of credit as security for rents in favor of lessor); see also In re TECH HIFI, Inc., 49 B.R. 876, 879 (Bankr. D. Mass. 1985) (stating debtor's offer to post up to six months rent in form of letter of credit is "adequate assurance of future performance"). Back To Text

[105] See 11 U.S.C. § 365(f) (1994) (stating "trustee many assign an executory contract or unexpired lease only if trustee assumes such contract or lease . . . and adequate assurance of future performance by the assignee of such contract or lease is provided whether or not there has been a default in such contract or lease."); see also In re Washington Capital Aviation & Leasing, 156 B.R. 167, 175 (Bankr. E.D. Va. 1993) (deciding evidence debtors presented was insufficient to establish adequate assurance of future performance by assignee); In re Peterson's LTD, 31 B.R. 524, 528 (Bankr. S.D.N.Y. 1983) (reasoning intended use by assignee cigar store provided adequate assurance, since cigar store would be selling high quality goods). Back To Text

[106] See 11 U.S.C. § 365(k) (1994); see also In re Joshua Slocum, LTD., 99 B.R. 261, 266 (Bankr. E.D. Pa. 1989) (holding trustee and/or debtors' estate not liable for any breach occurring after assignment of lease); see also Am. Flint Glass Workers Union v. Anchor Resolution Corp., 197 F.3d 76, 80−81 (3d Cir. 1999) (explaining § 365(k) does not apply "to novate the obligations of a debtor under a contract that is not assigned by the debtor in its entirety."). Back To Text

[107] See 11 U.S.C.§ 365(l) (1994) (entitling landlord to security deposit from assignee of lease); see also L.R.S.C. Co. v. Rickel Home Ctrs., Inc. (In re Rickel Home Ctrs.), 209 F.3d 291, 298−99 (3d Cir. 2000) (explaining heightened protection afforded to landlords under Code). Back To Text

[108] Where the existing security deposit is in the form of a letter of credit that has not been drawn as of the assignment date, the landlord, the issuer and the assignee all are likely to require the assignee to procure issuance of a new letter

of credit and execute a new reimbursement agreement. It also is likely that the parties would not agree to leave the debtor's reimbursement obligation in place to cover future draws, since the debtor is supposed to be released from future liability upon assignment, and its creditors likely would object to the debtor's retention of contingent liability over which it has no control. However, if the landlord already has drawn down the letter of credit, it may agree to hold the letter of credit proceeds as the replacement tenant's security deposit. See Musika v. Arbutus Shopping Ctr. (In re Farm Fresh Supermarkets of Md., Inc.), 257 B.R. 770, 772 (Bankr. D. Md. 2001) (finding trustee could not recover letter of credit proceeds after lease was sold to assignee and landlord both consented to assignment and continued to hold previously−drawn proceeds as security deposit on behalf of assignee); see also Christopher Leon, Letters of Credit: A Primer, 45 MD. L. REV. 432, 442−43 (1986) (observing key to all letters of credit is that issuer's obligations are independent of underlying contract); 5 COLLIER ON BANKRUPTCY ¶ 549.04[1] (Lawrence P. King et al.., 15th ed. rev. 1997) (indicating property of estate does not include proceeds of letter of credit paid to creditor who is beneficiary of letter). Back To Text

[109] This also includes monetary obligations that are not related to the debtor's use of the premises. See 11 U.S.C. § 365(d)(3) (1994) which states:

The trustees shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time of performance shall not be extended beyond such 60−day period ...

Id.; Cukierman v. Uecker (In re Cukierman), No. 00−15085, 2001 U.S. App. LEXIS 19737, at *12 (9th Cir. Sept. 7, 2001) (finding "further rent" payments which constituted repayment of promissory notes were within scope of § 365(d)(3)). Back To Text

[110] See In re Cukierman, 2001 U.S. App. LEXIS 19737, at *12 (finding all post−petition rent accrued under lease through rejection date, including amounts denominated "further rent," enjoys administrative priority); Montrose Centre v. Northeast Consumer Tech. Stores, Inc. (In re Appliance Store, Inc.), 148 B.R. 234, 243 (Bankr. W.D. Pa. 1992) (indicating that post−petition rental payments, debtor's share of real estate taxes and other charges due under lease through effective date of rejection, are entitled to administrative expense priority regardless of fact that debtor formally notified lessor one month before entry of rejection order); In re Granada, Inc., 88 B.R. 369, 371 (Bankr. D. Utah 1988) (stating rent becomes due on nonresidential real property during 60−day period immediately following entry of order for relief under § 365(d)(3) is allowable as administrative expense without necessity of notice and hearing as ordinarily required by § 503(b)(1)). Back To Text

[111] See Nostas Assocs. v. Costich (In re Klein Sleep Products, Inc.), 78 F.3d 18, 28 (2d Cir. 1996) (deciding claims for future rent arising out of assumed leases qualify as administrative expenses and are not capped at year's worth of unpaid rent); In re Johnston, Inc., 164 B.R. 551, 555 (Bankr. E.D. Tex. 1994) (indicating that limits within § 502(b)(6) do not apply to administrative expenses); Samore v. Boswell (In re Multech Corp.), 47 B.R. 747, 751 (Bankr. N.D. Iowa 1985) (stating purpose of § 502(b)(6) is no longer germane in case of assumed lease since resulting liabilities are elevated to priority level). Back To Text

[112] At least one court has found that where the post−petition period included the first day of the month, when rent was due that day, and the lease was rejected as of the second day of the month, the landlord's administrative priority claim included the entire month's rent. See Koenig Sporting Goods, Inc. v. Morse Rd. Co. (In re Koenig Sporting Goods, Inc.), 203 F.3d 986, 989 (6th Cir. 2000) (rejecting pro−ration method and holding § 365(d)(3) entitled landlord to full month's rent on first day of month, regardless of occupancy after payment due date); Lisa S. Gretchko, Last in Line: Timing is Everything When Rejecting the Commercial Real Estate Lease, 2000 ABI JNL. LEXIS 77, at *1−2 (Sept. 2000) (noting Koenig case was first to address issue that had thus far split other courts and was first to conclude that debtor tenant must pay all rent that becomes due during post−petition pre−rejection period under lease, even when possession of property is relinquished mid−month). Some courts pro rate this amount for the number of days the lease was in effect after the petition date, so that the debtor tenant just pays rent for each day of the post−petition, prerejection period. See, e.g., In re Travel 2000, Inc., 264 B.R. 444, 450−51 (Bankr. W.D. Mich. 2001) (distinguishing

facts of Koenig and applying proration method); In re Learningsmith, Inc., 253 B.R. 131, 134 (Bankr. D. Mass. 2000) (indicating debtor only obligated to pay for 22/184 of total bill because debtor was only in bankruptcy 22 out of 184 days); Newman v. McCrory Corp. (In re McCrory Corp.), 210 B.R. 934, 940 (S.D.N.Y. 1997) (stating landlord only entitled to pro−rata share of rent for month debtor tenant actually occupied premises). But see Centerpoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.), 2001 WL 1193207, at *2 (3d Cir. Oct. 10, 2001) (holding duty to pay taxes for pre−petition periods arose post−petition and therefore was obligation payable in full pursuant to § 365(d)(3)). Back To Text

[113] See infra II. D.5., Landlord's Damages upon Rejection. Back To Text

[114] See In re Pacific Arts Publ'g, Inc., 198 B.R. 319, 324 (Bankr. C.D. Cal. 1996) (finding attorney's fees arose from rejection of lease and therefore should be examined and allowed or disallowed as pre−petition claim); In re Fin. News Network, Inc., 149 B.R. 348, 350 (Bankr. S.D.N.Y. 1993) (explaining result of deeming post−petition breach to have occurred pre−petition is, absent security, to give non−debtor party general unsecured claim); see also Unsecured Creditor's Comm. of Highland Superstores, Inc. v. Strobeck Real Estate, Inc. (In re Highland Superstores, Inc.), 154 F.3d 573, 581 (6th Cir. 1998) (adopting widely accepted rule that lessor's damages arising out of debtor's lease rejection are to be determined by lease and applicable state law and then limited by § 502(b)(6)). Back To Text

[115] See Kuske v. McSheridan (In re McSheridan), 184 B.R. 91, 96 (B.A.P. 9th Cir. 1995) (explaining landlord's claim for damages is determined by state law and by terms of lease or contract between parties); In re Iron−Oak Supply Corp., 169 B.R. 414, 417 (Bankr. E.D. Cal. 1994) (indicating bankruptcy law leaves issue of property rights in assets of bankruptcy estate to states); In re Fin. News Network, Inc., 149 B.R. at 352 (indicating amount of damages upon default is dictated by terms of lease). Back To Text

[116] 11 U.S.C. § 502(b)(6) (1994); H. REP. NO. 95−595 (explaining § 502(b)(6) limits damages landlord can recover from debtor by compensating landlord for his loss, while not allowing claim so large as to prevent other general unsecured creditors from recovering money from estate). Back To Text

[117] See In re McSheridan, 184 B.R. at 97 (indicating that § 502(b)(6) balances interests of landlords against those of other creditors by preventing landlords from receiving windfall); Leslie Fay Cos. Inc. v. Corp. Property Assocs. (In re Leslie Fay Cos., Inc.), 166 B.R. 802, 808 (Bankr. S.D.N.Y. 1994) (observing § 502(b)(6) to be grounded in principles of ratable distribution); In re Rodman, 60 B.R. 334, 335 (Bankr. W.D. Okla. 1986) (holding landlord's full claim is not allowed in light of fact that landlord has opportunity to mitigate his damages by reletting property). Back To Text

[118] See In re Rose's Stores, Inc., 179 B.R. 789, 791 (Bankr. E.D.N.C. 1995) (finding taxes and insurance constitutes "rent reserved," but certain general maintenance and utilities do not as they are generally related to tenant's use of property rather than its value); In re Farley, Inc. 146 B.R. 739, 746 (Bankr. N.D. Ill. 1992) (finding rent reserved under § 502(b)(6) includes any payment specifically denominated as rent, and also includes charges that relate directly to or affect value or worth of property and are fixed regular payments); In re City Stores, 23 B.R. 201, 204 (Bankr. S.D.N.Y. 1982) (identifying landlord's reletting commissions and actual and necessary repairs as "damages resulting from termination"); Int'l Coins & Currency v. Barmar Corp. (In re Int'l Coins & Currency, Inc.), 18 B.R. 335, 338 (Bankr. D. Vt. 1982) (indicating § 502 (b)(6) only applies to rent, not to claims for damages to premises). Back To Text

[119] See In re McSheridan, 184 B.R. at 100 (indicating "rent reserved" includes all payments payable under lease regardless of their classification); see also In re Pacific Arts Publ'g., 198 B.R. 319, 324 (Bankr. C.D. Cal. 1996) (following McSheridan in finding attorney's fees are not "rent reserved;" payments must both be denominated as rent and relate to value of lease and property). Laura B. Bartell, Revisiting Rejection: Secured Party Interests in Leases and Executory Contracts, 103 DICK. L. REV. 497, 503 n. 103 (1999) (citing McSheridan case and indicating most courts have concluded § 502(b)(6) is intended to capture all claims occasioned by rejection). Back To Text

[120] See Kuske v. McSheridan (In re McSheridan), 184 B.R. 91, 99−100 (B.A.P. 9th Cir. 1995) (stating three−part test must be satisfied for claim to be allowed as "rent reserved"); see also In re Andover Togs, Inc., 231 B.R. 521, 540 (Bankr. S.D.N.Y. 1999) (choosing to use three−part McSheridan test to see if "Electricity Rent Inclusion Factor"

claim constitutes "rent reserved," as this test results in most comprehensive analysis); Fifth Ave. Jewelers, Inc. v. Great E. Mall, Inc. (In re Fifth Ave. Jewelers, Inc.), 203 B.R. 372, 380−81 (Bankr. W.D. Pa. 1996) (using three part test in McSheridan to determine that real estate taxes, insurance and common area maintenance fees are included in § 502(b)(6), but liquidated damages, service charges, reletting costs and interest on state court judgment are not). Back To Text

[121] See In re McSheridan, 184 B.R. at 99−100 (establishing three−part test); see also Smith v. Sprayberry Square Holdings, Inc. (In re Smith), 249 B.R. 328, 337−38 (Bankr. S.D. Ga. 2000) (using three−part test to determine that fixed minimum rent, common area maintenance, and taxes are allowed as "rent reserved," and excused rent is not); In re PPI Enterprises (U.S.), Inc., 228 B.R. 339, 349 (Bankr. D. Del. 1998) (adopting McSheridan test and disallowing landlord's charge for attorney's fees, which were denominated "additional rent" in lease); In re Zenith Electronic Corp., 241 B.R. 92, 108 (Bankr. Del. 1999) (adopting McSheridan approach). Back To Text

[122] In re McSheridan, 184 B.R. at 102 (rejecting distinction between damages arising from non−performance of obligations under lease prior to rejection and damages "caused" by termination because statute encompasses all damages caused by nonperformance). Back To Text

[123] Id. at 102 (indicating § 502(b)(6)(A) "encompasses damages arising from breach of any and all lease covenants upon termination of lease."); see also In re Mr. Gatti's, Inc., 162 B.R. 1004, 1011 (Bankr. W.D. Tex. 1994) (finding rejection of lease equals "termination" of lease and it effectuates breach of each and every provision of lease). But see In re Fifth Ave. Jewelers, 203 B.R. at 379 (stating "[a]lthough Congress sought to limit the amount of damages that a landlord could recover from a bankrupt debtor, Congress only placed said limitations on a landlord's claims for post−petition damages ...."). Back To Text

[124] See Bank of Maui v. Estate Analysis, Inc., 904 F.2d 470, 472 (9th Cir. 1990) (declining to decide authoritative effect of B.A.P. decision, but recognizing disagreement among courts); Compare Philadelphia Life Ins. Co. v. Proudfoot (In re Proudfoot), 144 B.R. 876, 879 (B.A.P 9th Cir. 1992) (holding Ninth Circuit B.A.P opinions are binding on all bankruptcy courts in Ninth Circuit in absence of contrary opinion of district court in district where bankruptcy court is located), with In re Enriquez, 244 B.R. 156, 159 (Bankr. S.D. Cal. 2000) (analyzing cases addressing issue and concluding, as matter of law, B.A.P opinion is binding only when opinion is in very case before bankruptcy court and, in all other circumstances, B.A.P opinions are "persuasive authority," but not binding). Back To Text

[125] See In re Best Products Co., Inc., 229 B.R. 673, 678 (Bankr. E.D. Va. 1998) and cases cited therein; see also In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231−32 (Bankr. D. N.D. 1992) (allowing claim for debtor/tenant's failure to repair and maintain premises); In re Goldblatt Bros., Inc., 66 B.R. 337, 346 (Bankr. N.D. Ill. 1986) (allowing claim for reconstruction costs based on provisions of lease). Back To Text

[126] See In re Carbone's Deli, Inc., 2000 Bankr. LEXIS 1131, at *10 (Bankr. Conn. Sept. 28, 2000) (finding base rent included in "rent reserved"); In re Heck's, Inc., 123 B.R. 544, 546 (Bankr. S.D. W.Va. 1991) (finding "rent reserved" included minimum rent, real estate taxes, insurance, and common area maintenance fees). Back To Text

[127] See In re Handy Andy Home Improvement Ctrs., 222 B.R. 571, 574 (Bankr. N.D. Ill. 1998) (allowing limited recovery); In re Best Products Co., Inc., 229 B.R. at 677 (allowing recovery). Back To Text

[128] See 4 King, COLLIER ON BANKRUPTCY ¶ 502.3[7][i](15th ed. 2001); see also In re S. Cinemas, Inc., 256 B.R. 520, 536 (Bankr. Fla. 2000). But see In re Episode USA, 202 B.R. 691, 696−97 (Bankr. S.D. 1996) (declining to require mitigation of damages in commercial lease). Back To Text

[129] In re Handy Andy Home Improvement Centers, Inc., 222 B.R. at 574; see also In re Atl. Container Corp., 133 B.R. 980, 989 (Bankr. N.D. Ill. 1991) (reducing claim by security deposit amount). Back To Text

[130] See 4 King, COLLIER ON BANKRUPTCY ¶ 502.3[7][h](15th ed. 2001); see also Schwartz v. C.M.C., Inc. (In re Communicall), 106 B.R. 540, 546 (Bankr. N.D. Ill. 1989) (requiring excess to be turned over to trustee as part of

debtor's estate); In re Danrik, Ltd., 92 B.R. 964, 968 (Bankr. N.D Ga. 1988) (stating same). Back To Text

[131] As described, see supra II. D.5., Landlord's Damages Upon Rejection, this amount could well exceed one year's rent, depending on pre−petition defaults and the remaining term of the lease (i.e., if the remaining term is 20 years or more, 11 U.S.C. § 502(b)(6) caps the landlord's claim at the sum of pre−petition damages plus three years' rent). Back To Text

[132] Tenants and their bankruptcy trustees may argue that landlords improperly are evading the effects of § 502(b)(6) by obtaining large letters of credit, and should not be permitted to transmute their capped claims into uncapped claims. This argument does not differ materially from the argument that an unsecured landlord's claim should not, by virtue of the honoring of a letter of credit, be transmuted into a secured claim (of the letter of credit issuer), and is trumped by the independence principle. See supra note 101. Back To Text

[133] It is noteworthy that a landlord is entitled to obtain from a guarantor that is not itself a debtor in bankruptcy payment of all amounts due under a debtor's lease, regardless of the 11 U.S.C. § 502(b)(6) cap. See Bel−Ken Assoc. LP v. Clark, 83 B.R. 357, 358−59 (D. Md. 1988) (stating nondebtor guarantor not protected by 11 U.S.C. § 502(b)(6) cap). On the other hand, the cap has been held to apply to limit the landlord's claim against a guarantor of a lease where the guarantor itself is a debtor in a bankruptcy case. See Arden v. Motel Partners (In re Arden), 176 F.3d 1226, 1229 (9th Cir. 1999). An issuer's obligation to pay the beneficiary is a direct obligation, not a secondary obligation such as a guaranty, and an issuer is not a "guarantor" of the debtor's obligations under the lease. See Beach v. First Union Nat'l Bank of N.C. (In re Carley Capital Group), 119 B.R. 646, 648 (W.D. Wisc. 1990) (stating letter of credit issuers are not within definition of guarantors). But see In re Dow Corning Corp., 244 B.R. 705, 715 (Bankr. E.D. Mich. 1999) (criticizing in dicta In re Slamans, 69 F.3d 468 (10th Cir. 1995), for finding a letter of credit issuer is different from a guarantor, and stating, "[i]n the Sixth Circuit, co−liability exists when each party is obligated to pay the same person for the same benefits, even if the obligations of each party arise from a different source.") Since even a mere guarantor is liable to the landlord regardless of the 11 U.S.C. § 502(b)(6) cap, the landlord clearly ought to be able to draw all amounts that it is permitted to draw under the letter of credit, and to retain all such amounts that the landlord would be permitted to retain in the absence of the tenant's bankruptcy case. Back To Text

[134] Courts that incorrectly deem letter of credit issuers to be co−obligors of the debtor on its lease may apply 11 U.S.C. § 502(e) (which limits the claims of codebtors and parties that "secure" a debtor's obligations) and 11 U.S.C. § 502(b)(6) to limit the issuer's claim. However, the claim under the reimbursement agreement properly should be treated as an independent claim, not a claim of a co−obligor or surety under the lease, and should be allowed accordingly. Back To Text

[135] See supra note 81 (discussing In re PPI Enterprises, Inc., and related text). Back To Text