AN UPDATE ON THE BANKRUPTCY LAW OF LARGE LETTERS OF CREDIT FOR LEASES

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Editors' Synopsis: When landlords accept large letters of credit in lieu of cash deposits as security for commercial leases, and the tenant files for bankruptcy before the end of the lease term, the landlord may find that the Bankruptcy Code limits the usefulness of the letter of credit. In this Article, the author explains how the Bankruptcy Code causes this "Claim Cap Problem" and offers guidance on how a landlord can avoid this result.

A tenant under any commercial lease will often deliver a letter of credit in place of a cash security deposit as a way to give the landlord comfort that the tenant will perform its obligations under the lease. If that letter of credit (L/C) exceeds a year's rent and the tenant (Tenant) later files bankruptcy, then the landlord (Landlord) may find to its surprise that the L/C does not give Landlord the security for Tenant's obligations that Landlord expected. And Landlord's mortgage lender (Lender) may share Landlord's concerns.

These issues took center stage during the dotcom boom and subsequent bust around the turn of the twenty-first century. But the same issues can arise whenever Landlord accepts an L/C that exceeds a year's rent. One might expect to see more such L/Cs, at least in some markets, as all participants in real estate transactions refocus on fundamentals such as credit quality and credit enhancement.

Landlord's problems with taking a large L/C all trace back to 11 U.S.C. section 502(b)(6). That section of the Bankruptcy Code applies only to Landlords under real property leases. It potentially limits the amount of any claim[1] that Landlord can assert in Tenant's bankruptcy "for damages

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[1] Submission and acceptance of a claim does not, of course, in and of itself ensure payment. It merely begins the discussion.

resulting from the termination of a lease of real property"[2] (the Claim Cap). Absent the Claim Cap, Landlord could assert a claim in Tenant's bankruptcy for whatever damages Landlord could assert in state court. The Claim Cap disallows some part of those damages in bankruptcy—potentially a very substantial part.

If Landlord's damages do not exceed one year's rent, the Claim Cap creates no problem or issue, and bankruptcy law will typically allow Landlord to file a claim for the entire amount of Landlord's damages.[3] If, however, Landlord's damages exceed that level, Landlord may find that the Claim Cap limits Landlord's claim. More specifically, Landlord's claim arising from Tenant's breach of the lease will be capped at whichever of these two alternatives is lower: (1) 15% of the remaining rent under the lease[4] or (2) three years' rent.[5] Landlord can also include in its claim any unpaid rent due before Tenant filed.[6] The Claim Cap seeks to prevent Landlord's claim from excessively diluting or crowding out the claims of other unsecured creditors.[7]

After the Claim Cap shrinks Landlord's claim, Landlord then joins the throng of unsecured creditors who typically receive pennies on the dollar for their claims. Landlord potentially suffers four times: first, if the lease defines or limits Landlord's damages; second, if state law further limits Landlord's claim; third, if the Claim Cap then further diminishes Landlord's claim; and fourth, if Landlord, with its diminished claim, becomes an unsecured creditor and might get paid only partially, just like any other unsecured creditor. Maybe Congress does not like Landlords.

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[2] 11 U.S.C. § 502(b)(6)(2006). Landlords may therefore try to characterize their claims as something else, a technique this Article explores later.

[3] *See* § 502(b)(6)(A).

[4] This piece of the formula will go down over time. Thus, although an L/C for more than a year's rent may not at lease signing cause a Claim Cap Problem, *see infra* note 9 and accompanying text, such an L/C can start to create a Claim Cap Problem as the remaining lease term drops. Landlord will often agree, however, that Tenant can reduce the amount of the L/C over time as well, thus preventing a creeping Claim Cap Problem. (One problem for Landlord prevents a second problem.)

[5] *See* § 502(b)(6)(A).

[6] Bankruptcy law measures the Claim Cap as of the earlier of the date when Tenant filed bankruptcy or the date when Landlord repossessed the leased premises. *See* § 502(b)(6). The preceding summary of the Claim Cap ignores certain issues involving definitions and calculations not important in this Article.

[7] *See* Jennifer L. Nassiri, *Letters of Credit and Lease Rejection Damages Under Section 502(b)(6)*, DLA PIPER, NEWS & INSIGHTS, June 2006, *available at* http://dlapiper.com/section502b6.

Can Landlord avoid these problems by taking a huge security deposit? Suppose, for example, that Tenant gave Landlord a cash security deposit of $5X, but the Claim Cap limited Landlord's claim in Tenant's bankruptcy to $2X. What happens? Tenant's bankruptcy estate could force Landlord to disgorge $3X, the excess cash security deposit above the Claim Cap.

Landlord might intuitively think it can solve that problem by taking an L/C instead of cash as Tenant's security deposit. Under the same facts, if Landlord held an L/C for $5X instead of cash in the same amount, could Tenant's bankruptcy estate force Landlord to hand over (or "disgorge"[8]) any L/C proceeds in excess of $2X? Recent case law compels precisely this result (from Landlord's perspective, the Claim Cap Problem).[9] In other words, taking an L/C does not eliminate Landlord's risk of seeing the Claim Cap diminish Landlord's claim to $2X.

What if Landlord does not actually convert the $5X L/C into cash or at least has not done so when Tenant files bankruptcy? If and when Landlord eventually draws upon the L/C and converts it into cash, does the cash then become a security deposit subject to the Claim Cap? Could Tenant's estate then recover the excess cash proceeds beyond the Claim Cap?[10] If Landlord has not yet drawn upon the L/C—has not yet converted the L/C into cash—can Landlord ignore the Claim Cap? Does the answer depend on whether Landlord draws upon the L/C before or after Tenant's bankruptcy filing?

Until 2001, Landlord would not have thought that the Claim Cap could prevent Landlord from retaining the full proceeds of Tenant's L/C. In the one case that considered the Claim Cap Problem before 2001,[11] the court easily ruled for Landlord. Although the court did not go into great detail

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[8] Use of the word "disgorge" in this context demonstrates how word choices and labels can dictate outcomes. If Tenant or its trustee in bankruptcy were instead asking a court to require Landlord to forfeit the benefit of a freely negotiated security package, the use of the latter words to describe the relationship might help dictate the opposite result. Other words that can drive outcomes sometimes include *fair*, *the public interest*, *greedy*, *progressive*, *reform*, and *change*.

[9] *See* Solow v. PPI Enters., Inc. (*In re* PPI Enters., Inc.), 324 F.3d 197 (3d Cir. 2003).

[10] *See* Anton N. Natsis, Joseph M. Davidson, & Michael S. Greger, *Structuring Deals with High-Tech Tenants—The Good, the Bad and the Ugly*, 18 CAL. REAL PROP. J. 4 (Summer 2000) (also discussing further structuring issues).

[11] Musika v. Arbutus Shopping Ctr. L.P. (*In re* Farm Fresh Supermarkets of Md., Inc.), 257 B.R. 770 (Bankr. D. Md. 2001).

about the facts or analysis or indicate whether it thought the Claim Cap even applied, the decision included these Landlord-friendly comments:

> The letter of credit at issue is a tripartite agreement that gave the landlord upon demand the right to obtain payment from a third party for which the debtor may be ultimately liable, but which the trustee cannot recover. . . .
>
> [N]either the letter of credit nor its proceeds were property of the debtor's estate, and therefore the trustee may not . . . recover them.[12]

Practitioners and commentators, including the author, considered the *Farm Fresh* result intuitively obvious and appropriate.[13] They focused ostensibly on the "independence principle" underlying all L/Cs and concluded, logically enough, that no Landlord holding an L/C should need to worry about the Claim Cap Problem.[14] The independence principle at the foundation of all L/C transactions should mean that when Landlord accepts an L/C, that L/C creates a two-party relationship purely between Landlord and the issuer of the L/C (Issuer), which does not involve Tenant in any way. Thus, any Claim Cap Problem should belong entirely to Issuer, not Landlord.

These practitioners believed that the Claim Cap should limit only Landlord's claims against a debtor in bankruptcy—a topic with no relevance at all to a Landlord's right to draw upon an L/C or to apply the proceeds of such a draw, because both take place outside Tenant's bankruptcy and arise only under the Landlord-Issuer relationship.[15] A minimally reported Delaware case reached exactly that conclusion in 2001.[16]

The world changed in 2000 and 2001 when dotcom Tenants began their famous "meltdown." As part of that meltdown, many new dotcom companies found themselves in bankruptcy—soon after they had just signed large

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[12] *Id.* at 772.

[13] *See, e.g.*, Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 764 (2001) ("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).").

[14] *See id.*

[15] *See id.*

[16] *In re* Darwin Networks, Inc., No. 01-4601, 2001 Bankr. LEXIS 1689, at *1 (Bankr. D. Del. 2001) (granting landlord summary judgment on section 502(b)(6) issue). The reported decision contains no facts or discussion. Copies of the underlying court papers (public documents) are on file with the author, whose firm represented a party in the dispute.

leases that were expensive and difficult to negotiate, and often required huge L/Cs, given the state of the market at the time.

The cases that arose out of that meltdown showed that the Claim Cap Problem is real. Perhaps unsurprisingly, the bankruptcy courts protected the dotcom debtors.[17] In those cases, Landlords learned that the independence principle did not give them the armor they thought it gave them. Some Landlords learned they had to disgorge any "excess" L/C proceeds to the bankrupt estate—a most unwelcome surprise.[18]

The law in this area evolved quickly. Three circuit courts and a bankruptcy appellate panel took up the Claim Cap Problem. Some of the decisions were not necessarily bad for Landlords, but none was good for Landlords.

In 2003, the Third Circuit decided one of these cases, *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.)*.[19] Solow—Landlord—drew upon the L/C and wanted to keep all the proceeds.[20] Going beyond the L/C, Solow also tried to assert a claim, subject to the Claim Cap, for unpaid rent against Tenant—PPI Enterprises (PPIE).[21] The court credited Landlord's L/C proceeds against Landlord's allowable claim.[22] The court regarded the L/C as being identical to a cash security deposit and called Landlord's position an attempt at an "end run around § 502(b)(6)."[23]

The decision emphasized substance over form, focusing on the parties' intent to use the L/C in place of a cash security deposit. The lease contained some language that invited the court to treat the L/C as being really a security deposit, just like a cash security deposit. For example, the lease described the L/C as being "in lieu of . . . cash security" that Tenant would replenish with cash if Landlord drew upon the L/C.[24] To the court, it was "clear the parties intended the [L/C] to operate as a security deposit."[25]

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[17] See *Solow v. PPI Enters., Inc.* (In re *PPI Enters., Inc.*), 324 F.3d 197 (3d Cir. 2003) and other cases discussed below.

[18] *See id.*

[19] 324 F.3d 197 (3d Cir. 2003).

[20] *See id.* at 201.

[21] *See id.*

[22] *See id.* at 210.

[23] *See id.* at 209.

[24] *Id.* at 210.

[25] *Id.*

Therefore, the court treated the L/C proceeds as a security deposit and offset them against the Claim Cap.[26]

The court feared that if it allowed Solow to keep the L/C proceeds and also make a bankruptcy claim up to the Claim Cap, it could leave PPIE's other creditors out in the cold—the injury that 11 U.S.C. section 502(b)(6) was supposed to prevent.[27] Solow could achieve double payment and more. He could keep all the L/C proceeds—free of the Claim Cap—and Issuer could assert a claim in PPIE's bankruptcy for that entire amount.[28] At the same time, Solow could file a claim, up to the Claim Cap, in PPIE's bankruptcy.[29] The court stated, however, that it "need not decide the underlying question" regarding the interaction between L/Cs and the Claim Cap because of the parties' clear intent in this case.[30]

Given the practical economic reality of the transaction and the words of the lease, the characterization of the L/C as a substitute for a cash security deposit hardly seems bizarre.

Although another court reached the same result, its approach suggested a somewhat more friendly view toward Landlord. In *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*,[31] Landlord again received an L/C, in the amount of $648,966, "as security for the faithful performance by [Debtor] of all [Debtor's] obligations."[32] This language, as in *Solow*, made the L/C sound like a substitute for a cash security deposit. To back the L/C, Tenant deposited with Issuer more than $650,000.[33] When Tenant defaulted, Landlord drew upon the L/C.[34]

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[26] This result was the holding of *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944), half a century before. *Oldden* and some later legislative history support the notion that a debtor Tenant can reach its cash security deposit. Landlord "will not be permitted to offset his actual damages against his security deposit and then claim for the balance under this paragraph. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph." H.R. REP. NO. 95-595, at 353–54 (1977); S. REP. NO. 95-989, at 63 (1978).

[27] *See supra* note 23, at 14.

[28] *See id.*

[29] *See id.*

[30] *Id.*

[31] 306 B.R. 295 (B.A.P. 9th Cir. 2004).

[32] *Id.* at 297 (alteration in original).

[33] *See id.* at 297.

[34] *See id.*

The bankruptcy court subtracted the L/C proceeds from Landlord's capped claim.[35] The Bankruptcy Appellate Panel for the Ninth Circuit agreed. The panel even went a step further, treating all L/C proceeds as a cash security deposit that the estate could recover from Landlord to the extent it exceeded the Claim Cap.[36]

The court focused on how Landlord's L/C draw affected the debtor's estate.[37] Even though the L/C itself was not property of the estate,[38] a draw triggered creation of an equivalent liability for the estate.[39] Therefore, the court found no difference between a cash security deposit and an L/C, the only actual distinction between them being the location of the money.[40] The decision turned almost entirely on the fact that Tenant had made a cash deposit with Issuer to back the L/C[41]—a line of inquiry that the independence principle would suggest should make no difference. The logic of the independence principle would suggest allowing Landlord to draw upon the entire L/C, with Issuer facing the burden of having to give up part of the cash security deposit. It was Issuer, after all, who should have assumed all risks and burdens of Tenant's creditworthiness and possible bankruptcy, and how any such bankruptcy might affect the L/C.

Two years later, the Ninth Circuit again focused on whether Tenant had posted a cash deposit to back its L/C. In *AMB Property, L.P. v. Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*,[42] Landlord accepted a $1 million L/C instead of a cash security deposit.[43] A year later, Tenant filed bankruptcy and rejected the lease.[44] Applying the Claim Cap, Landlord asserted a claim for $2 million against Tenant's estate.[45] Landlord also drew upon the entire L/C.[46]

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[35] *See id.*
[36] *See id.* at 301.
[37] *See id.*
[38] *See id.* at 299.
[39] *See id.* at 300–01.
[40] *See id.* at 301.
[41] *See id.*
[42] 416 F.3d 961 (9th Cir. 2005).
[43] *See id.* at 962.
[44] *See id.*
[45] *See id.*
[46] *See id.* at 963.

Tenant tried to reduce Landlord's claim by the $1 million that Landlord had drawn under the L/C.[47] Following the *Mayan Networks* logic, the Ninth Circuit agreed with the Bankruptcy Appellate Panel that when a debtor's property fully collateralizes an L/C, as was the case here, the L/C is just like a cash security deposit and will reduce Landlord's claim against the debtor Tenant.[48]

Mayan Networks and *AB Liquidating Corp.* leave open a crucial question: What if a debtor does not deliver cash collateral for the L/C? The *Mayan Networks* decision may offer Landlords some hope. The court said that if a debtor does not deliver cash security for an L/C, then the relationship among Landlord, Tenant, and Issuer more closely resembles a third-party guarantee.[49] Under that structure, if the guarantor (Issuer) paid the guarantied obligation, the Claim Cap should not limit those payments by Issuer (treating Issuer as a guarantor).[50]

The *Mayan Networks* decision focuses, at least in dicta, on how the L/C structure affects the debtor's estate. If an L/C draw does not hurt the debtor's estate, then the court might treat it like a "third-party guarantee" not subject to the Claim Cap.[51] Conversely, as in *Mayan Networks*, if cash collateral backs an L/C and Landlord draws on the L/C, then the resulting use of cash collateral will reduce cash otherwise available to the debtor, thus hurting the estate and the other creditors, and supporting the court's adverse treatment of Landlord.[52]

The same bankruptcy appellate court had reached much the same result in an earlier case, *In re Condor Systems, Inc*.[53] There, an employee held an L/C, but Issuer had no security.[54] When the employee drew upon the L/C, the court decided that a limit on employee claims in bankruptcy (similar to

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[47] *See id.* at 961.

[48] *See id.* at 965 n.3.

[49] Redback Networks, Inc. v. Mayan Networks Corp. (*In re* Mayan Networks Corp.), 306 B.R. 295, 300 (B.A.P. 9th Cir. 2004).

[50] *See id.* (citing *In re* Modern Textile, Inc., 900 F.2d 1184 (8th Cir. 1990); Bel-Ken Assocs. Ltd. P'ship v. Clark, 83 B.R. 357 (D. Md. 1988); Things Remembered, Inc. v. BGTV, Inc.,151 B.R. 827 (Bankr. N.D. Ohio 1993)).

[51] *See id.* An ordinary guarantee does not impair the debtor's estate, because it does not increase the debtor's total liabilities. It merely converts a debtor's direct liability (to a creditor who holds a guarantee) into a reimbursement liability (to the guarantor who paid the direct creditor).

[52] *See id.*

[53] CEI Sys., Inc. v. Condor Sys. Inc. (*In re* Condor Sys., Inc.), 296 B.R. 5 (B.A.P. 9th Cir. 2003).

[54] *See id.*

the Claim Cap) did not apply because the L/C draw did not diminish employer's estate.[55] This case, however, concerned an L/C in the employment context governed by § 502(b)(7), thus limiting its direct relevance to leases.[56]

The decision nevertheless suggests that the independence principle still lives, at least to some degree and in some contexts. The court stated that if an L/C is not intended to be a security deposit under a lease,[57] "the obligation to pay is direct and primary as between [Issuer] and [Landlord] and is . . . 'independent' of performance, or lack thereof, by anyone else" and that "settled letter of credit law requires [Issuer] to pay [Landlord], even if [Tenant] is broke."[58]

In 2005, the Fifth Circuit took up these issues and embarked on an entirely different analytical journey. In *EOP-Colonnade of Dallas Limited Partnership v. Faulkner (In re Stonebridge Technologies, Inc.)*,[59] Stonebridge, as Tenant, obtained an L/C for $1.5 million and backed it by pledging a certificate of deposit.[60] When Tenant filed bankruptcy and rejected the lease, EOP, as Landlord, drew upon the L/C.[61] Content with the proceeds of the L/C because they exceeded EOP's damages, EOP did not file a proof of claim for its actual-lease-rejection damages.[62]

The bankruptcy court found for Tenant's estate, characterizing the L/C proceeds as a security deposit subject to the Claim Cap.[63] The Fifth Circuit,

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[55] *See id.* at 18–19; *In re* Mayan Networks, 306 B.R. at 300 (citing *In re* Condor Sys., Inc.).

[56] *See In re* Condor Sys., Inc., 296 B.R. at 8. The court stated: "we agree . . . that § 502(b)(6) provides an unreliable analogy for §502(b)(7), and thus view security deposits on leases as distinguishable." *Id.* at 18. The court also stated, though: "[i]t does not follow, however, that every letter of credit or other third-party guarantee constitutes a security deposit. Rather, even in the landlord-tenant arena, parties must intend that it be a security deposit." *Id.* at 19. Thus, where the parties do not intend an L/C to operate as a security deposit, the logic of *In re Condor* may apply, so proceeds from such an L/C might not reduce the amount allowed under the Claim Cap.

[57] *See id.* The court noted that "[s]ecurity deposits are peculiar, term-of-art creatures of contract that have a rich history in the specialized field of landlord-tenant law," and that "[w]here a letter of credit . . . is intended to be a security deposit under a lease, it may be appropriate to analyze the situation as involving a security deposit." *Id.* at 18.

[58] *Id.*

[59] 430 F.3d. 260 (5th Cir. 2005).

[60] *See id.*

[61] *See id.* at 263.

[62] *See id.* at 265.

[63] *See id.* at 263–64.

however, decided that EOP could keep the L/C proceeds—regardless of the Claim Cap—because the Claim Cap plays no role if Landlord never files a claim against Tenant's bankruptcy estate.[64] Section 502(b)(6) only caps claims against the bankruptcy estate, the court wrote.[65] In contrast, a draw upon an L/C does not involve a claim against the bankruptcy estate because it concerns contractual rights and duties separate from the relationship of the creditor and the debtor.[66]

The Fifth Circuit mentioned the independence principle, treating the relations among the parties in a manner consistent with the independence principle and with intuitively obvious expectations about L/Cs outside bankruptcy.[67] The court suggested this approach when it said Issuer's obligations to Landlord, as beneficiary under the L/C, remain intact so long as Landlord does not alter the relationship with the debtor by filing a claim against the bankruptcy estate.[68] But the court avoided the more challenging question of what would happen if Landlord did make such a claim.[69]

Though a significant amount of ink has been spilled recently (including by the author, here and elsewhere) on the Claim Cap Problem, the recent cases do seem to stand for three principles:

(1) Whenever Landlord retains a cash security deposit, the bankruptcy courts will first apply the Claim Cap against Landlord's claim, then credit the cash security deposit against Landlord's remaining claim.[70]

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[64] *See id.* at 271.

[65] *See id.* at 270.

[66] *See id.* at 269.

[67] Likewise evidencing the Fifth Circuit's respect for the independence principle, the court had previously decided *Kellogg v. Blue Quail Energy Inc.* (*In re* Compton Corp.), 831 F.2d 586 (5th Cir. 1987). There, the Fifth Circuit stated "[i]t is well established that a letter of credit and the proceeds therefrom are not property of the debtor's estate" and that "the independence principle [is] the cornerstone of letter of credit law." *Id.* at 589–90.

[68] *See In re* Stonebridge Techs., Inc., 430 F.3d at 271.

[69] Two later L/C cases undercut the notion that Landlord's failure to file a claim somehow limits the court's ability to deal with L/C issues at a Tenant debtor's initiative. *See* First Ave. W. Bldg., LLC v. James (*In re* OneCast Media, Inc.), 439 F.3d 558 (9th Cir. 2006) (bankruptcy jurisdiction for dispute over whether L/C proceeds overcompensated Landlord for its actual damages); Two Trees v. Builders Transp., Inc. (*In re* Builders Transp., Inc.), 471 F.3d 1178 (11th Cir. 2006) (similar). Neither of these cases implicated the Claim Cap. Neither decision indicated that Landlord had filed a claim in Tenant's bankruptcy proceeding. Yet the bankruptcy courts were perfectly willing to hear Tenant's claims that Landlord should refund some part of the L/C proceeds. *See also* Richard Levy, Jr., *Recent Developments in the Bankruptcy Treatment of Letters of Credit Under Commercial Real Estate Leases*, PRAC. REAL EST. LAW., March 2007, at 27, 32.

[70] *See* Oldden v. Tonto Realty Corp., 143 F.2d 916, 922 (2d Cir. 1944).

(2) Courts will treat L/Cs as security deposits when Tenants give Issuer cash security. The presence of an actual cash deposit (even in Issuer's hands) makes the whole arrangement too much like a cash security deposit to treat it as anything else.

(3) If the lease shows the parties intended to use an L/C in place of a cash security deposit, this increases the likelihood a court will apply the Claim Cap. Any suggestion that the L/C replaces or substitutes for a cash security deposit will raise a red flag.

The *Mayan*, *AB Liquidating Corp.*, and *PPI* decisions agree on the points above.[71] Courts will not allow Landlords to end-run the Claim Cap by restructuring cash security deposits as L/Cs, or by having some third party (Issuer) hold Tenant's cash in a way that really just benefits Landlord. The courts have looked behind such arrangements, scrutinizing the overall relationship among the parties to see how the L/C operates in deciding whether to subject the L/C proceeds to the Claim Cap. Courts have done this based on the perceived congressional rationale that the Claim Cap was designed to prevent Landlords' claims from depleting Tenant debtors' estates to the detriment of other creditors.[72]

These decisions leave open one major question: How will the courts treat non-collateralized L/Cs? Will the courts treat them as sufficiently remote from the debtor Tenant to establish a third-party guarantor relationship—as the *Mayan* court suggested? Or will the courts still view them as just another form of cash security deposit? (Those who argue that a security deposit is a security deposit—regardless of form, including an L/C—would also argue that the absence of collateral for the L/C should make no difference.) If courts choose the latter path and treat even an unsecured L/C as equivalent to a cash security deposit, the L/C, as a protective tool for Landlords, may well be irreparably injured, at least where Tenant provides the L/C and its amount causes a Claim Cap Problem.

Though today's state of the law seems unfavorable for L/C beneficiaries, Landlords should keep in mind a bit of history in the law of L/Cs. This area is marked by a history of occasional "weird" cases that produce

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[71] *See* AMB Prop., L.P. v. Official Creditors for the Estate of AB Liquid'g Corp. (*In re* AB Liquid'g Corp.), 416 F.3d 961 (9th Cir. 2005); Redback Networks, Inc. v. Mayan Networks Corp. (*In re* Mayan Networks Corp.), 306 B.R. 295 (9th Cir. 2004); Solow v. PPI Enters., Inc. (*In re* PPI Enters., Inc.), 324 F.3d 197 (3d Cir. 2003).

[72] *See, e.g.*, EOP – Colonnade at Dallas L.P. v. Faulkner (*In re* Stonebridge Techs., Inc.), 430 F.3d 260, 269 (citing H.R. REP. NO. 95-595 (stating the purpose of the statute was to compensate Landlords but not to permit a claim that would prevent recovery by other creditors)).

unexpected results, usually because a court wants to "do justice" and finds a creative way to do so but does not sufficiently respect the fundamental principles of L/Cs. Such cases are ultimately ignored or discredited in many instances.[73] It is probably overoptimistic, however, to anticipate the same fate for the Claim Cap Problem cases this Article discusses.

The Claim Cap Problem can drive the structuring of any lease transaction where the business deal contemplates that Landlord will obtain substantial protection—more than a year's rent—through a cash security deposit or an L/C.[74]

If Landlord plans to obtain a large L/C, Landlord and its counsel should try to structure the transaction in a way that mitigates or even eliminates the Claim Cap Problem. To try to do that, Landlord can choose from a menu of possible techniques, many of them listed below. Some of these techniques overlap and may suggest other techniques or other problems.

None of these techniques is guaranteed to solve the Claim Cap Problem, but the following amount to a reasonably exhaustive (and perhaps exhausting) list of possibilities:[75]

- *Look Behind Reimbursement Arrangement.* As noted above, the courts seem to look less favorably on L/Cs that are backed by cash deposits. Thus, Landlord should try to assure that Issuer has not received a cash deposit or other collateral.
- *Do Not File Claim.* The *Stonebridge* opinion suggests courts may be more willing to respect the independence of Issuer's payment to Landlord if Landlord does not file a claim, thus creating a relation-

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[73] *See* Twist Cap, Inc. v. Se. Bank of Tampa (*In re* Twist Cap), 1 B.R. 284 (Bankr. M.D. Fla. 1979) (enjoining unsecured creditors from drawing L/Cs because it would indirectly hurt debtor); *see also* Celotex Corp. v. Edwards, 514 U.S. 300 (1995) (enjoining draws on surety bonds much like L/Cs, to prevent financial chaos for debtor); Comm. of Creditors Holding Unsecured Claims v. Koch Oil Co. (*In re* Powerine Oil), 59 F.3d 969, 969–71 (9th Cir. 1995) (obligor paid an L/C-backed obligation; creditor released L/C; obligor filed bankruptcy; court required creditor to "disgorge" those payments as "preferences").

[74] In addition to the Claim Cap Problem, Landlord may also need to consider state-law limitations on how Landlord can use L/C proceeds.

[75] Lender may care a great deal about: (1) which technique Landlord chooses and (2) how Lender obtains a perfected and reliable security interest in, and practical ability to control, Landlord's rights. Any structure should consider Lender's agenda and might require a tri-party agreement among Landlord, Lender, and Tenant. For an example of such an agreement, see II COMMERCIAL LEASING 1009 (Joshua Stein, ed., New York State Bar Assoc. 2004). An updated version of that agreement with commentary is in progress and available from the author upon request.

ship between itself and the bankruptcy proceeding.[76] Because Federal Rule of Bankruptcy Procedure 3004 authorizes a debtor to file a claim on behalf of a creditor, though, this theory of "Landlord uninvolvement" seems unlikely to have much practical impact.[77] Some post-*Stonebridge* cases also suggest Landlord cannot excuse itself from the bankruptcy process so easily.[78]

- *Guaranty Backed by L/C.* The *Mayan* decision suggests that if an L/C draw will not diminish Tenant's estate, then the L/C proceeds will not be subject to the Claim Cap because the L/C will, in effect, amount to a third-party guarantee relationship.[79] To accomplish this, the parties can agree to tie the L/C—not to the lease, but instead to a totally independent third-party guaranty of the lease, issued by a third-party guarantor (the Guarantor). Guarantor's general credit would not back the lease but would simply serve the purpose, Landlord hopes, of protecting the L/C from the Claim Cap.[80] If Guarantor itself were to file, then cases indicate that the Claim Cap would limit Landlord's claim against Guarantor.[81] But if Tenant and only Tenant filed, it is generally believed that the Claim Cap would not protect the nonbankrupt Guarantor.[82] Landlord could then draw upon the L/C based on the nonbankrupt Guarantor's failure to pay rather than because of anything related to Tenant or the

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[76] *See In re* Stonebridge Techs., Inc., 430 F.3d at 267–70.

[77] *See* William Medford & Bruce H. White, *Application of § 502(b)(6)'s Lease Rejections: An Update on Damages Cap to Letters of Credit*, 25-2 AMER. BANKR. L.J. 36, 41 (March 2006).

[78] *See* footnote 69.

[79] *See* Redback Networks, Inc. v. Mayan Networks Corp. (*In re* Mayan Networks Corp.), 306 B.R. 295 (9th Cir. 2004).

[80] As a rather obvious alternative, Guarantor's general credit could replace the L/C (particularly if Guarantor's general credit would alone support Issuer's issuance of the L/C).

[81] If Issuer took security from Guarantor for the L/C, Landlord would again find itself in a conundrum discussed in text.

[82] In other words, if Tenant is in bankruptcy but Guarantor is not, then as a matter of state-law guaranty enforcement, the state court should not give the nonbankrupt Guarantor the benefit of the Claim Cap. This result seems logical, at least from Landlord's perspective. The author has, however, been advised of occasional state-law cases that hold otherwise and apply Tenant's Claim Cap to Landlord's claim against a nonbankrupt Guarantor. Notwithstanding diligent research, the author has not been able to locate any such cases. If any reader is aware of them, a reward of one dollar will be paid for the correct citation(s). No security of any kind is being offered for the making of this payment. Any further discussion of how the Claim Cap applies to a nonbankrupt guarantor lies outside the present discussion. Anyone who proposes to use a guaranty in this context should at least consider this question.

lease. Landlord would say, with some basis, that the Claim Cap has no relevance to Landlord's rights against Guarantor or under the L/C. Under this structure, Guarantor would be either: (1) creditworthy enough that bankruptcy is unlikely; or (2) a bankruptcy-remote entity. In either case, Tenant and its principals need not have any interest in, or control of, Guarantor. Perhaps it is best if they do not. Guarantor might even be a third-party bonding company.[83] To avoid dragging Tenant's bankruptcy back into the picture, one could even require Guarantor to waive any right of reimbursement from Tenant if Landlord draws upon the L/C. In some permutations, this structure amounts to a miniaturized version of structured, off-balance-sheet financing. It may represent a very attractive and workable way to solve the Claim Cap Problem, although Landlord would need to consider the usual suretyship and related issues arising with any guaranty[84] and consider the vicissitudes that have started to befall similar structures in the larger financial world.

- *No Cash Security.* Landlord could plan to draw upon the L/C only to the extent necessary to cure defaults as and when they occur, never converting the L/C into a cash deposit to back the lease.[85] Under this strategy, Landlord would avoid creating an attractive pot of money in which Tenant's estate could claim an interest. Instead, the L/C would remain an L/C—undrawn upon to the extent possible—at all times. This approach requires no verbiage in the L/C beyond language that clearly allows partial draws.[86] It also requires enough flexibility in the lease to assure that whenever Landlord does decide to draw upon the L/C and the circumstances justify it, Landlord will be able to do so—and immediately disburse the L/C proceeds—without violating the lease.[87] Landlord then would plan to try to persuade the bankruptcy court that the undrawn L/C is

[83] The bonding company would bring to the transaction the fact that it is highly unlikely to go bankrupt. The L/C itself would not be backed by the bonding company's credit but probably by cash collateral from the bonding company.

[84] *See generally In re* Mayan Networks Corp., 306 B.R. 295; 11 U.S.C. § 502.

[85] *See* Natsis, Davidson & Greger, *supra* note 10 and accompanying text; *contra* Solow v. PPI Enters., Inc. (*In re* PPI Enters., Inc.), 324 F.3d 197 (3d Cir. 2003).

[86] *See, e.g. In re* PPI Enters., Inc., 324 F.3d at 209–10.

[87] *See, e.g.*, AMB Prop., L.P. v. Official Creditors for the Estate of AB Liquid'g Corp. (*In re* AB Liquid'g Corp.), 416 F.3d 961 (9th Cir. 2005); *In re* Mayan Networks Corp., 306 B.R. 295.

something very different from a cash security deposit (it isn't cash or anything like cash!) and should not be subject to disgorgement.[88]

- *Do Not Draw.* As a corollary to the preceding measure, Landlord should try very hard to defer any draw under the L/C until after Tenant has filed—and ideally until Tenant has exited—bankruptcy, recognizing that a draw before or during Tenant's bankruptcy creates a very attractive cash target and simply asks for trouble.[89] Of course, if the L/C is about to expire, Landlord will have no choice but to draw upon it, even if Landlord must do so before Tenant files or during the bankruptcy. But if Landlord can wait until after Tenant files (or better yet until after the bankruptcy is over), this may place Landlord in a better position than if, at any time during the bankruptcy, Landlord held cash constituting the proceeds of a previous draw. A typical Landlord would, of course, want to draw first and ask questions later. Thus the suggestion in this paragraph would require Landlord to display an unusual and perhaps unrealistic level of restraint.[90]
- *Generous Expiry Date.* To avoid the risk of being forced to draw upon an L/C that is about to expire and hence end up holding a pot of cash that might attract the interest of the bankruptcy court, Landlord might insist that the expiry date of the L/C be no earlier than ninety days or more after the scheduled expiration date of the lease.[91] In other words, Landlord would refuse to accept the more typical "evergreen" L/C, which creates an annual risk of nonrenewal and conversion to cash. Few Issuers are willing to issue such a long-term L/C, particularly for the types of Tenants that need to deliver these L/Cs.[92] If Landlord accepted such an L/C, Landlord

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[88] *See supra* note 8 and accompanying text.

[89] *See In re* Mayan Networks, Inc., 306 B.R. at 298–99.

[90] Before Landlord's counsel advises its client to resist its natural instinct, Landlord's counsel should reconfirm that once Tenant files, Landlord will still be able to draw upon the L/C, taking into account the specific lease and the effect of the automatic stay.

[91] In Landlord's ideal world, any Tenant bankruptcy would toll the expiry date of the L/C. Few Issuers would accept such concept.

[92] As a compromise measure, Issuer might issue a long-term L/C but have the right to replace the L/C at any time with a third-party surety bond or cash collateral at the account party's expense. Any such surety bond probably would be backed by Issuer's cash or credit, but the account party would be obligated to repay immediately any amounts drawn on the bond. This technique gives Issuer benefits equivalent to those of an evergreen L/C without

might want to rethink the circumstances justifying a draw upon on the L/C, based on the wide variety of bad events that might occur over a very long lease term. Additional triggers might include Tenant bankruptcy (whether or not already a default under the lease); an Issuer downgrade; other issues relating to the L/C (such as Issuer's failure to maintain a convenient office to draw upon the L/C); or even Tenant's failure to meet certain financial tests. In the event of any such draw, what would Landlord do with the L/C proceeds? As suggested above, Landlord may prefer to hold an L/C that Landlord has not yet drawn upon but could draw upon at any time.

- *Immediate Use of L/C Proceeds.* If any default occurred under the lease, the lease could allow Landlord to draw upon the entire L/C, but use the proceeds first to cure Tenant's default and then only to prepay rent at the back end of the lease (and for no other purpose). Tenant would have no interest in such proceeds. After such prepayment of rent, Landlord might go a step further and require Tenant to restore the L/C, to restore its full amount as originally intended, but this may be excessive. Would a bankruptcy court treat such a prepayment of back-end rent as anything other than a cash security deposit? Probably not.
- *No Interest in L/C Proceeds.* The lease could include language in which Tenant purportedly disclaims any interest in the L/C proceeds and acknowledges that Landlord holds them free of any rights of Tenant. These words may be rather meaningless to the extent that the lease imposes specific obligations on Landlord regarding use of those proceeds, including an obligation to release L/C proceeds to Tenant under certain circumstances.
- *L/C Independent of Tenant and Lease.* Landlord could insist that the L/C come from anyone other than Tenant. For example, in the case of a dotcom Tenant, Landlord could insist that the L/C come from the venture capitalists behind Tenant, rather than from Tenant itself. Landlord could, as a matter of its own protection, look behind Issuer's reimbursement arrangements for the L/C and insist that the reimbursement obligation fall upon anyone other than Tenant, in a way that gives the reimbursing party no rights of any kind

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burdening Landlord with a cash deposit. But how would the bankruptcy court treat the surety bond? Would it raise the Claim Cap Problem all over again?

against Tenant.[93] As noted earlier, the application of the Claim Cap may vary depending on whether, and to what degree, Tenant must reimburse Issuer for any draw made under the L/C.

- *Key Money and Back-End Free Rent.* Tenant might deliver key money and be entitled to equivalent free rent at the end of the term, but only in the form of a refund for the last few months of rent at the end of the term and only if Tenant has not defaulted. A court would probably regard the structure as a slightly disguised cash security deposit.
- *Separate Loan.* The parties might eliminate the cash security deposit (or L/C security arrangements) and add to the transaction an independent tenant improvements loan from Landlord to Tenant, backed by a leasehold mortgage or an L/C, collaterally assigned, if necessary, the Lender.[94] That loan could even be unsecured, except by the L/C. In that case, the L/C might simply back a separate payment stream from Tenant to Landlord—a promissory note requiring certain payments fully secured by the L/C—having no relation at all to the lease and not secured except by the L/C.[95] The parties would expressly agree that the payment stream constitutes something other than "rent" and has no connection to the lease. (The Claim Cap applies to claims for "damages resulting from the termination of a lease of real property."[96]) In this case, though, the lease and the note might need to be cross-defaulted. Other issues

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[93] The "independence principle" of L/Cs would suggest that such an analysis should be irrelevant, but the courts have performed such analyses anyway and have considered, among other things, whether Tenant's reimbursement obligations were unsecured or backed by cash collateral.

[94] Any such structure creates its own pile of new issues. Does such a loan create usury problems? Can this loan and the lease safely be cross-defaulted? If so, will a bankruptcy court pay any attention (either in a "good" way or in a "bad" way) to the cross-default? Does such a loan create regulatory or reporting issues for publicly-traded real estate investment trusts (REITs)? "Bad income" for any REIT, public or private? Under income tax regulations, what interest rate must Landlord charge? Does such a loan work, more generally, as a tax and accounting matter? Should Landlord use a separate entity as the tenant-improvement financier, with completely separate documentation? Will a court look beyond the "loan" and treat the entire relationship as a "lease"? How does Lender perfect its position? What if the lease terminates other than because of a Tenant default, such as because of casualty or condemnation? These questions probably just scratch the surface.

[95] Lender would, again, probably want to receive a collateral assignment of Tenant's obligations.

[96] 11 U.S.C. § 502(b)(6) (2006).

about the interaction of rights and remedies (see, e.g., the earlier discussion on Tenant's right to a refund of prepaid rent) might ultimately force the parties to tie the two documents together. Any such linkage could reopen the Claim Cap Problem.

- *Do Not Call L/C a Security Deposit.* Collectively, the courts that have considered this issue have emphasized substance over form.[97] If an L/C contains language that makes it look like a mere substitute for a cash security deposit, the courts will in all likelihood treat it as such.[98] Therefore, all references to the L/C in the lease should make clear the L/C is something other than—and very different from—a cash security deposit.
- *Other Recharacterization.* One could try other ways to recharacterize the L/C and its proceeds as something other than a subterfuge to replace a cash security deposit. For example, Tenant could agree to reimburse Landlord's leasing brokerage commissions, vacancy period losses, and tenant improvement costs for the lease—or the next lease of the same space—if the lease terminated early because of a default (the Leasing Expense Reimbursement). The Leasing Expense Reimbursement could formulaically drop over time. One would then treat the Leasing Expense Reimbursement as an obligation entirely independent of the lease and not constituting rent. A separate agreement would govern the Leasing Expense Reimbursement, saying the arrangement has nothing to do with compensation for use and occupancy of real estate, but merely protects Landlord regarding certain leasing expenses. Landlord would need to structure and document this arrangement in a way that negates any argument that it's really "rent." For example, Landlord should not characterize any Leasing Expense Reimbursement as "rent" in monthly bills, or have the right to collect it by enforcing the lease. If the lease provides for "rent" adjustments, the formula for those adjustments should disregard the Leasing Expense Reimbursement. The obligor for the Leasing Expense Reimbursement might be a party other than Tenant, such as Tenant's principals or venture capital backers. In that case, the documents should make very clear that Tenant has no obligation to pay or

[97] *See generally* Redback Networks, Inc. v. Mayan Networks Corp. (*In re* Mayan Networks Corp.), 306 B.R. 295, 297 (9th Cir. 2004); Solow v. PPI Enters., Inc. (*In re* PPI Enters., Inc.), 324 F.3d 197 (3d Cir. 2003).

[98] *See In re* Mayan Networks Corp., 306 B.R. at 297.

reimburse this amount or any part of it. The parties undertaking the Leasing Expense Reimbursement would need to waive any indemnity or reimbursement claims against Tenant. Landlord would have no remedies under the lease for nonpayment of Leasing Expense Reimbursement, and the lease would not even mention it.[99] Landlord might obtain a leasehold mortgage on the lease to secure the obligation to pay Leasing Expense Reimbursement. Although such a mortgage may, as a practical matter, induce payment of Leasing Expense Reimbursement, its value as credit support seems dubious at best, because of both the unreliable valuation of the collateral and the bankruptcy issues that travel with any secured obligation.

- *Prohibit Cash Security.* The lease could also affirmatively forbid Tenant from converting an L/C into a cash security deposit (such as by allowing the L/C to expire without being renewed). Any such conversion would be an event of default in and of itself. If the L/C expired, Landlord would not merely have the right to draw upon the L/C to create a cash security deposit, but also all remedies for an event of default. This prohibition on a cash security deposit would reflect the logic that because of the Claim Cap Problem, Landlord is better off with an L/C (which might suffer from the Claim Cap Problem)[100] than with a cash security deposit (which will definitely suffer from the Claim Cap Problem). If Landlord loses the benefits of holding an L/C, then Tenant loses the benefits of holding the lease. Of course, Landlord would then immediately face the Claim Cap Problem if Tenant filed bankruptcy.
- *Personal Guaranty.* Obtain a personal guaranty that simply indemnifies Landlord against any risks arising from the Claim Cap Problem.
- *Limit L/C to One Year's Rent.* As long as an L/C does not exceed one year's rent, no Claim Cap Problem should arise.[101] The Claim Cap formula also sometimes permits a higher maximum claim, though never more than three years rent.[102] Landlord can therefore avoid the whole issue simply by not structuring a transaction that requires an L/C exceeding the Claim Cap. An L/C for one year's

[99] This strategy is the exact opposite of Landlord's usual strategy of wanting to label as "rent" each and every obligation in any way related to a lease.

[100] *See supra* p.303.

[101] *See supra* p.300.

[102] *See id.*

rent should always be safe. Or, to the extent that the L/C would exceed the Claim Cap, one could substitute any of the mechanisms suggested above—a mix-and-match solution to the problem but a solution nevertheless. The hybrid nature of such a solution would probably create unnecessary issues, complexity, concerns, and drafting. Landlord and Lender should probably take one road or another, but not more than one. It all depends on context and circumstances, though.

- *Take the Risk.* As another possibility, Landlord might not worry about the Claim Cap Problem and simply take the risk and either (1) hope the L/C serves its purpose and Tenant stays out of bankruptcy; (2) hope the courts change their mind and decide that there is no such thing as a Claim Cap Problem for a Landlord that accepts a huge L/C; or (3) recognize that in bankruptcy the L/C will have given Landlord and Lender substantial comfort but not quite as much comfort as they really wanted. This possible response to the Claim Cap Problem ignores a risk (perhaps a substantial risk) inherent in the structure of the transaction. It requires Tenant to bear the full cost and burden of obtaining an L/C without giving Landlord and Lender the absolute certainty of having the full corresponding benefit of a reliable L/C. In other words, it creates an economic absurdity, which usually implies that the parties can find some alternative and superior solution to the problem. Such a solution should give Landlord, Lender, or both, an incremental benefit at no incremental cost to Tenant and should therefore be preferred. The concept of ignoring the problem is, however, by no means uncommon and might be viewed as Landlord's taking a business risk on the lease—a decision that Landlord's Lender might or might not second-guess—in an effort to "get the deal done" because of emergency circumstances that leave little time for consideration of legal niceties.[103] Although Landlord may be willing to tolerate some uncertainty because of these issues,[104] any Lender will probably find

[103] As a matter of risk management, Lender's or Landlord's counsel should recognize that business decisions like this one often correlate with short memories. Later, when the risk actually hits, all fingers point to counsel. Therefore, counsel may want to keep a copy of counsel's memo warning of the bankruptcy risks of such a structure.

[104] The author would argue, however, that Landlord should not accept such uncertainty any more than Lender should. An L/C is intended to provide security, not insecurity and issues. If it does not reliably provide security, then it fails to achieve its central and single purpose. If Landlord is willing to accept a structure that infringes on Landlord's security in

> them particularly vexatious, because Lender will probably want to control any L/C that Tenant delivers and will probably accept less uncertainty than Landlord.[105]

The fundamental question that the Claim Cap Problem forces the parties to think about is simply the following: How can Landlord, Lender, and Tenant treat the L/C as the functional equivalent of a cash security deposit without actually calling it a security deposit or otherwise giving Tenant an interest in the L/C proceeds? The answer is not necessarily easy or straightforward. Similar questions and issues arise, and are regularly solved, throughout secured-lending transactions as a result of the need to consider bankruptcy law.

Stepping back a bit from the details, Landlord may often find that the best solution to the Claim Cap Problem consists of having Guarantor obtain and deliver the L/C to back the guaranty. In many cases, this solution should simply do the job.

Some of the strategies described above hinge upon trying to separate the L/C from the lease, from Tenant, or from both, so Landlord can argue in Tenant's bankruptcy that the L/C has nothing to do with either. But wouldn't Tenant insist on having the right to require Landlord to return the undrawn L/C or prepaid rent under some circumstances? For example, Tenant would probably, and legitimately, want Landlord to return the L/C or its proceeds if: (1) Tenant cures its defaults; (2) Landlord defaults under the lease, and Tenant validly terminates it; (3) the building burns down, and Landlord elects not to restore; (4) the entire building is condemned; or (5) the lease expires under its terms, and Tenant performs all its obligations. In all these cases, Tenant would probably want the L/C returned even if the lease otherwise devotes seventeen pages to the propositions that Tenant has no interest of any kind in the L/C and the L/C has nothing to do with the lease or Tenant's rent.

Would Tenant's rights to the L/C under these circumstances give Tenant enough of an interest in the L/C and its proceeds for the bankruptcy court to say the L/C is really just like a cash security deposit and Tenant's delivery of an L/C doesn't solve the Claim Cap Problem? The answer may be that if Landlord has enough negotiating leverage, Landlord can insist that

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the one forum where security is most likely to matter, then Landlord did not really care about security in the first place.

[105] The interplay between Landlord and Lender—Lender's control of the L/C and its proceeds—would go in a separate three-party agreement outside the scope of this Article. For a sample agreement, *see* II COMMERCIAL LEASING, *supra* note 75. An updated version of that agreement with commentary is in progress and available from the author upon request.

Tenant give up any right to the L/C or its proceeds under any circumstances and simply bear the risk of losing the L/C under the circumstances listed in the previous paragraph. In the dotcom leasing frenzy of the late 1990s, Landlords might have been able to get away with taking that position (or Tenants might have not noticed it because they were in too much of a hurry to sign their leases),[106] but the commercial leasing market of the early twenty-first century, particularly after mid-2007, seems rather different.

Tenant may also insist that if Landlord converts an L/C to cash, then: (1) Landlord can use such cash only to cure Tenant's defaults under the lease, to pay damages for Tenant's default under the lease (precisely the obligation that is subject to the Claim Cap) or both; and (2) Tenant will receive any interest Landlord earns on the cash. Would such requirements also tend to support a claim by Tenant's bankruptcy estate to the L/C proceeds?

Also, if the L/C proceeds are intended to be a security deposit that is not a security deposit, what does state law say about those proceeds? For example, if state law imposes certain requirements about how Landlord holds and applies a security deposit, must Landlord comply with them? What happens if Landlord does not? Would state law recharacterize as a security deposit either the L/C or its proceeds or one of the creative alternative arrangements suggested above?

How do the answers to these questions change if Guarantor delivers the L/C solely to back its guaranty, all in such a way that the L/C has no direct connection to the lease?

When appropriate, Landlord's counsel may want to invest some additional time and effort thinking about these and other questions and otherwise trying to solve any possible Claim Cap Problem.

In the excitement of worrying about the Claim Cap Problem, though, Landlords, Lenders, and their counsel should not lose sight of some other issues that might limit Landlord's ability to draw upon an L/C if Tenant files bankruptcy.

First, Landlord will want to confirm that the lease, or other appropriate documentation, will in fact allow Landlord to draw upon the L/C in the event of a Tenant bankruptcy, even if Tenant is not otherwise in default under the lease.[107] Of course, some comments earlier in this Article suggest

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[106] For some subsequent history about that marketplace, *see, e.g.*, Joshua Stein, *The Best Strategies for Extricating a Company From Its Long-Term Office Lease Obligations*, START-UP & EMERGING COMPANIES, June 2001, at 1.

[107] If a lease defines Tenant bankruptcy as a default, such a provision will be unenforceable against a Tenant in bankruptcy. *See* 11 U.S.C. § 365(e) (2006). Could

that such a draw might not always be wise. But Landlord would prefer to retain the ability to make such a draw at any time after a Tenant bankruptcy filing.

Landlord should also consider the other conditions and requirements for making a draw, as stated in the lease.[108] Are those conditions flexible enough to cover every possible circumstance when Landlord might want to make a draw? Will Landlord be able to satisfy those conditions with no involvement or help by Tenant? Will the courts sustain the amount of Landlord's draw? Is the amount of the draw a penalty? Is Landlord's measure of damages enforceable?[109]

The use of an L/C makes it possible for Landlord to draw first and discuss later many of the interesting issues this Article covers. Landlord should, however, consider these issues when structuring and documenting the lease and the L/C, so the lease can help support a future argument for validity of the L/C and any draw upon the L/C—even aside from the Claim Cap Problem.

Landlord nevertheless rely on it to support an L/C draw? In the alternative, if Landlord wants the ability to draw the L/C upon a Tenant bankruptcy, should Landlord document that right somewhere outside of the lease? In the L/C itself? And should Tenant be a party to that agreement? If not, who should be? *See* Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 739 (2001) ("The landlord also needs to be able to draw under the letter of credit upon the . . . tenant's bankruptcy. . . . This condition must be stated in the letter of credit in order to be enforceable.").

[108] All drawing conditions and procedures for the L/C should appear in the lease alone and not in the L/C, at least from Landlord's perspective. Once the lease allows a draw, Landlord should be able to draw by submitting the L/C and a sight draft, satisfying no other requirements in the L/C. Sometimes, though, Landlord cannot achieve this desired level of simplicity.

[109] Recent developments in the larger financial world have created another set of questions for any Landlord to consider when accepting an L/C. What happens if Issuer fails, or is taken over by the Federal Deposit Insurance Corporation? Does Landlord still have a claim against Issuer? Does the lease require Tenant to replace the L/C under this circumstance? These issues lie beyond the present discussion.