LETTERS OF CREDIT: ADDITIONAL COLLATERAL

VS.

APPARITIONAL CREDIT ENHANCEMENT

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Across our nation's landscape are emerging capitols for high technology, biotechnology, and dot-com economies.

Though the mortality rate of companies in these industries may be greater than the unemployment rate in third world countries, the actual demand for office, as well as research and development space remains higher than wished-for stock prices. Yet those who remember those famous Denver sunsets of yesteryear when you could see beautiful evening skies through empty office buildings, cautiously envision one day when those buildings being filled by workers of the new economy, may become empty boxes littered along Interstates.

Developers of 30,000 to 100,000 - plus square foot buildings for new companies that have yet to show a profit, are structuring leases to include letters of credit to secure a tenant's obligations under its lease. Letters of credit are required by landlords of yet to be creditworthy tenants or tenants who will burn through their venture capital far sooner than the termination date of their lease. Letters of credit are being utilized to secure tenant improvements, security deposits, and future rents for up to one year and more, and other monetary obligations. The stand by letter of credit is intended to be a form of security which can be quickly transformed to cash upon a default of a lease.

Lenders need to closely consider several business and legal issues in connection with loans that are being made to developers with commercial leases secured by a letter of credit. Particularly given the lending industry's new appetite for obtaining assignments of a tenant's letter of credit as additional collateral, critical issues need to be addressed, including the following:

Is a letter of credit truly additional collateral or an apparitional assignment of proceeds?

What will be the effect of bankruptcy?

Who can draw upon the letter of credit?

Are loan servicing departments structured to address issues pertaining to letters of credit?

What a developer and lender both wants to happen is the following:
A tenant secures its lease obligations by obtaining a letter of credit in favor of its landlord. Although there may be reductions in the letter of credit on an annual basis as the tenant ostensibly becomes more creditworthy, the landlord then has a commercial instrument that it may assign to a lender as additional collateral. In the simple scheme, upon a default of the lease by tenant, the lender immediately draws upon the letter of credit and impounds the cash proceeds as "real" additional security.

Issues requiring a lender's focus are the following:

Most leases are structured so that the letter of credit is reduced in equal amounts on an annual basis over the term of the lease, or heavily weighted toward reduction in early years of a lease, to the point that a letter of credit as a requirement under the lease disappears by the third to fifth year. In either event, additional security may have vanished by the time the last rat in the lab has died and there are no sources for additional funding or when the whims of Wall Street investors have directed the flow of venture capital to the new new-tech. Few, if any, leases, tie an annual reduction (or increase) in a letter of credit to capital requirements of a tenant.

In the event of bankruptcy, a letter of credit which was underwritten as a credit enhancement, becomes part of the debtor's/tenant's estate. Under the Bankruptcy Code, a tenant debtor may assume or reject a lease. If a tenant assumes its lease, it must pay all delinquent monetary obligations, as well as assume all monetary obligations under its lease at all future times. However, a tenant that exercises its right to reject its lease, may be entitled to a return of its security deposit. Bankruptcy Code Section 502(b)(6) specifically provides that a landlord may not collect an amount which is more than (a) unpaid rent up to the date of filing a bankruptcy petition, plus (b) one (1) years’ worth of rent or 15% of the remaining rent, whichever is greater. To the extent that proceeds from a letter of credit exceed the aforementioned calculation, a lender would not have a claim to such amounts. However, there is no safe harbor as to proceeds that are less than the statutory allowed amount reserved to landlords, since a landlord's claim to a security deposit for unpaid rent or future lease obligations is an unsecured claim in bankruptcy. Therefore, a landlord may only be entitled to pennies on the dollar. A lender may not truly have a secured lien on a letter of credit that it has been assigned as additional collateral.

If a letter of credit has been assigned to a lender, numerous questions arise as to the dynamics of the relationship between the tenant, landlord/borrower and lender. Among issues that may arise are the following:

- Does the letter of credit which is being assigned, meet the lender's criteria for letters of credit;

- If as landlord, a borrower is entitled to draw down on the tenant's letter of credit, and for whatever reason the lender does not timely draw, what liability does lender have to its borrower; and
• If a lender draws upon the letter of credit, but the tenant does not believe that the borrower as landlord had the right to draw, then there may be a three-way dispute. Other similar problems abound.

In the interplay between servicing software and personnel in servicing departments, lenders must be prepared to address all issues relating to letters of credit. Not only must servicing department personnel become part of the three-way relationship between tenant, landlord/borrower and lender, but servicing department personnel must also vigilantly monitor issues which interplay between the letter of credit and the lease. That is, servicing department personnel must be in communication with both a tenant and landlord/borrower in advance of the renewal date of the letter of credit to make sure that it is being renewed, and that it is in timely receipt of the renewal letter of credit, as well as the fact that if it is not renewed as required by the terms of lease, that it be drawn upon in a timely manner. Numerous other issues arise, including the importance of servicing department personnel to be familiar with the terms of the lease and its provisions relating to offsets that a tenant may apply to its letter of credit. Lastly, given the recent crisis alerts of the Mortgage Bankers Association and Commercial Mortgage Securities Association with respect to at least 3,000 lost loan documents in CMBS industry loan files, the location of where the letter of credit and renewal letter of credit are held is of paramount importance.

Assignments of letters of credit require compliance with Article 9 of the Uniform Commercial Code. Among legal documentation required in all transactions are a security agreement, UCC-1 Financing Statement, and written consent of the bank which issued the letter of credit.

Should letters of credit be accepted as additional collateral, recommended alternatives may include the following:

1. Lenders should only accept letters of credit as additional collateral directly from a borrower as opposed to an assignment of the borrower's letter of credit which avoids the pitfalls discussed above;
2. Leases should be evaluated to make certain that letters of credit may not be reduced on an annual basis if a tenant's capitalization falls below a certain level (and perhaps have an elevator clause in the event that capitalization falls).
3. Lenders, if they accept a letter of credit from a tenant or an assignment of a letter of credit from a tenant to borrower, at a minimum, should require clearly an unequivocal documentation that the tenant is providing a letter of credit as additional collateral on behalf of the borrower. Additionally, a closing condition should be that the applicable lease is amended to reflect that the tenant has given a letter of credit as additional collateral to the lender to secure the borrower's obligation under the applicable loan, and it is not to be construed as a security deposit or securing an obligation to pay rent or any lease obligation.
Letters of credit have traditionally been valuable tools in the lending industry, but lenders should proceed cautiously at a pre-commitment stage in determining how to best obtain the benefits of the additional collateral that is deemed essential to the making of a loan.