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Reviewing Letters of Credit as Security for Leases in Bankruptcy: Do You Receive What You Expect?

Under section 502(b)(6) of the United States Bankruptcy Code, a landlord's claim for damages under a lease rejected during the bankruptcy proceeding is capped at the greater of rent reserved under the lease for (a) one year; or (b) 15% or the remaining lease term, not to exceed three years. Under that calculation, a lease with a remaining term of 81 months or more would be entitled to claim greater than one year's rent.

In lieu of a cash security deposit, landlords frequently require the posting of a letter of credit. In most cases, the issuing bank will enter into a reimbursement agreement with the debtor procuring the letter of credit, pursuant to which the debtor promises to reimburse the issuing bank for the amount of any draws thereunder. Often, collateral is provided by the debtor to secure the reimbursement obligation.

It is well established that a cash security deposit will be applied to the capped claim. However, the law is uncertain regarding the proceeds of a letter of credit. If there is a draw under a letter of credit posted as security for a lease, are the proceeds applied to the "capped" claim, thereby reducing the amount that the landlord can recover from the bankruptcy estate, or instead can the proceeds be applied to the claim in excess of the cap, so the landlord can take the letter of credit proceeds and still assert the full capped claim in the bankruptcy case?

Three Circuit Courts of Appeal have addressed this issue. In *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003), a landlord asserted that the proceeds of an unsecured letter of credit should be applied to the claim in excess of the cap. Because the lease provided by its terms that the letter of credit could be provided in lieu of a cash security deposit, the court affirmed the bankruptcy court's determination that the letter of credit proceeds were in the nature of a security deposit and should be applied to the capped portion of the claim.

The Ninth Circuit Bankruptcy Appellate Panel in *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (B.A.P. 9th Cir. 2004) held that a draw under a letter of credit which the debtor collateralized had the same effect upon the bankruptcy estate as the application of a cash security deposit on the debtor's estate and required the proceeds to be applied to the capped claim

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amount. In *AMB Property, L.P. v. Official Creditors ex rel. AB Liquidating Corp. (In re AB Liquidating Corp).*, 416 F.3d 961 (9th Cir. 2005), following Mayan, the Ninth Circuit also held that the proceeds of a fully collateralized letter of credit should be applied to the landlord's capped claim without detailed analysis.

However, in *EOP-Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Technologies, Inc.)*, 430 F.3d 260 (5th Cir. 2005), the court reached a different conclusion. There, the landlord required a letter of credit and a cash deposit. The letter of credit was secured by a certificate of deposit pledged to the issuing bank. When the tenant filed bankruptcy, the landlord drew under the letter of credit but did not file a proof of claim in the bankruptcy case because it was fully covered by the cash security deposit and the letter of credit proceeds. The issuing bank filed a motion to apply the certificate of deposit to satisfy the claim arising under the reimbursement agreement with the debtor. The trustee stipulated to the application of the certificate of deposit by the bank in exchange for an assignment of the bank's claims against the landlord, and sued the landlord asserting, among other things, that the letter of credit was in the nature of a security deposit, citing *PPI* and *Mayan*. The landlord urged the bankruptcy court to rule that the proceeds in excess of the section 502(b)(6) cap should be returned.

The bankruptcy court agreed but the Fifth Circuit reversed. Under the independence principle, the circuit court found that letters of credit are not property of the estate, citing *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586 (5th Cir. 1987). The court noted that while the landlords in PPI and Mayan had filed proofs of claim, the Stonebridge landlord did not file a proof of claim and therefore section 502(b)(6), dealing with allowance of claims, did not apply. To decide otherwise would be to import an avoidance power into section 502(b)(6) where none existed.

In light of *Stonebridge*, a landlord that is the beneficiary of a letter of credit securing a lease obligation should carefully analyze its particular facts. If the amount paid under the letter of credit equals less than the section 502(b)(6) claim calculation, it appears that the landlord should file a proof of claim. Failing to do so would risk losing the potential recovery on the balance of its capped claim in the bankruptcy case (assuming, of course, that the estate had assets to pay unsecured claims) after application of the letter of credit proceeds. However, once the aggregate rent under the lease yielded a section 502(b)(6) claim that was less than the letter of credit proceeds, the landlord may choose not file a proof of claim because the letter of credit proceeds would be greater than the capped claim and, under Stonebridge, to file a claim would risk having to give up a portion

of those proceeds.