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Feature:

# Beware a False Sense of Security: Why Banks Should Think Twice Before Insuring Performance of Real Estate Leases

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Each year, banks insure performance of large numbers of commercial real estate leases through letters of credit. Such letters of credit run in favor of landlords, are backed by reimbursement agreements executed by tenants and are collateralized by tenants' cash collateral. Annual fees equal to 2 percent or more of the face amount of such letters are charged by issuing banks.

Should a tenant default on a lease supported by a letter of credit, demand is made by the landlord on the issuing bank. The bank first pays the landlord and then reimburses itself from the tenant's cash collateral. Despite the apparently problem-free nature of this arrangement, however, there are substantial risks attendant on a bank's issuing a letter of credit insuring a tenant's performance under a commercial real estate lease. These risks are endemic to real estate leasing and its disfavored treatment under § 502(b)(6) of the Bankruptcy Code.[1]

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[1] 11 U.S.C. § 502(b)(6). All further statutory references are to the Bankruptcy Code (11 U.S.C. §§ 101 *et seq.*).

The bankruptcy courts have treated § 502(b)(6)'s limitations on landlords' rights in varying ways where letters of credit are involved.[2] Significantly, the concurring opinion in *Redback Networks Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (9th Cir BAP 2004), took dead aim at the cash collateral banks receive in support of letters of credit issued at debtor-tenants' request. In *Mayan,* a debtor-tenant posted a letter of credit to insure performance of a pre-bankruptcy lease. Following bankruptcy, the landlord drew on the letter of credit. A dispute then arose over the proper amount of the landlord's unsecured claim, with the debtor-tenant maintaining that the landlord's unsecured claim--already limited to one year's rent under § 502(b)(6)--was further subject to reduction to the extent the landlord had previously drawn under the letter of credit.

Consistent with both *PPI* and *Stonebridge,* the *Mayan* majority held the letter of credit equivalent to a cash security deposit and, relying on the oft-cited decision of *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2nd Cir. 1944) (holding that proceeds from traditional cash security deposit reduced the unsecured claim allowed under § 63(a)(9) of the former Bankruptcy Act), held that the unsecured claim allowed under § 502(b)(6) must be reduced by the amount of the landlord's letter of credit draw. The majority

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[2] *See* *Solow v. PPI Enters. (U.S.) (In re PPI Enters. (U.S.)*, 324 F.3d 197 (3rd Cir. 2003) (applying limitations of § 502(b)(6) to letter of credit issued by bank in landlord's favor at tenant's request); *see, also,* *Faulkner v. EOP-Colonnade of Dallas LP (In re Stonebridge Techs. Inc.)*, 291 B.R. 63 (Bankr. N.D. Tex. 2003) (same holding, but requiring refund by landlord to debtor-tenant of excess over limitations of § 502(b)(6) received by landlord from bank); *but see* *Musika v. Arbutus Shopping Ctr. Ltd. P'ship. (In re Farm Fresh Supermarkets of Md. Inc.)*, 257 B.R. 770 (Bankr. D. Md. 2001) (letter of credit proceeds not § 541(a) property of bankruptcy estate and are not recoverable by bankruptcy trustee).

opinion in *Mayan* is noteworthy only for its suggestion that, had the letter of credit in question not been secured by the debtor-tenant's property, no offset against the landlord's unsecured claim would have been appropriate under § 502(b)(6) (*See Mayan,* at 300-301).

Mayan's concurring opinion is by Bankruptcy Judge **Christopher Klein** and is premised on what he describes as the holistic relationships among, *inter alia,* §§ 502(b)(6), 502(e), 524(e), 542 and 553(a). (*See Mayan* at 304, *citing* *United Savings Ass'n. v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365 (1988); 310.) Judge Klein's analysis starts with the proposition that § 502(b)(6) cannot be read as an absolute bar to landlords obtaining sums in excess of § 502(b)(6) limits because § 524(e) clearly contemplates full landlord recourse against non-debtor guarantors, even where this results in the landlord recovering sums well in excess of what is contemplated by § 502(b)(6). *Mayan* at 306-307.

Rather, in the court's view, § 502(b)(6) does not restrict landlords' remedies at all. What it does instead is cap debtor-tenants' liabilities. The distinction is best illustrated where, pre-petition, a debtor-tenant has hypothecated § 541(a) property of the estate to a bank to collateralize a letter of credit issued to insure lease performance for a period in excess of that allowed under § 502(b)(6). While *Stonebridge* ordered the landlord to make a refund to the debtor-tenant in such case, that is not the result favored by Judge Klein. Thus:

> The common assumption that letters of credit and other forms of guaranty or credit enhancements are devices by which the §§ 502(b)(6)-(7) caps can be circumvented is incorrect. Although landlords unquestionably get more out of their credit enhancements, the estate is never liable for more than the amount of the statutory cap.

> While it is true that one of the three contracts entailed in a letter of credit transaction is the reimbursement contract between the applicant (person obtaining letter of credit) and the issuer providing for reimbursement of the issuer for draws by the beneficiary on the letter of credit, that reimbursement contract right is treated in bankruptcy like any other co-obligation and leaves the issuer of the letter of credit subrogated to the rights of the beneficiary against the estate. Once the allowable claim (up to the § 502(b)(6) cap) is paid in full, then all other claims, including the issuer's claim against the estate on the reimbursement contract, are disallowed. To the extent the issuer holds collateral that is property of the estate and that is not eligible for offset under § 553(a) because the claim is "disallowed" under § 502 (which does not distinguish between secured and unsecured claims), the collateral has to be turned over to the estate under § 542.

*Mayan* at 310.

As of this writing, *Mayan*--which was decided on Feb. 5, 2004--has not been cited by any subsequent case on any basis and has been the subject of only a single commentator's note.[3]

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[3] *See* Shelby and McFadden, "Reader Alert: *In re Mayan Networks Corp.*--Letter of Credit Draw Effect on an Allowed Claim Under 11 U.S.C. § 502(b)(6)," *California Real Property Journal* (Summer 2004) Vol. 22, No. 3 (noting, *inter alia,* Judge Klein's concurring decision and its conclusion that "the bank issuing the L-C will be forced to disgorge the excess collateral (*i.e.,* amounts [of security] held in excess of the [Section] 502(b)(6) cap held against the L-C")).

**Conclusion**

Among debtor-tenant-applicants, creditor-landlords and banks issuing letters of credit to guarantee the performance of leases by debtor-tenant-applicants, bankruptcy is a zero-sum game. It used to be that, to the extent they could be bargained for pre-petition, letters of credit put the ultimate loss on debtor-tenant-applicants despite § 502(b)(6); no longer. Today, the ultimate fall guys are issuing banks, which foolishly think their security is always foolproof in bankruptcy. If *Mayan* is followed, then any security received by issuing banks for letters of credit in excess of the § 502(b)(6) cap is illusory, and the issuing banks are at the mercy of their debtor-tenant-applicants. Banks should modify their letter-of-credit practices accordingly, either by charging more for the risk of guaranteeing performance of real estate leases or, possibly, by avoiding issuing letters of credit for such purposes altogether.