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**516* SECURITIZATION OF FIRST PARTY SECURITY AS A SECTION 502(B)(6) AVOIDANCE DEVICE

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Banks have long issued standby letters of credit to back up a tenant's lease obligations. As explained in this article, however, recent caselaw seems to be putting a new spin on these traditional relationships.

A third party guaranty of a debtor-tenant's lease performance ("Third Party Security") has always been thought less vulnerable in bankruptcy than a debtor-tenant's pledge of its own property as a security deposit ("First Party Security"). [FN1] However, for section 502(b)(6) purposes at least, [FN2] the walls between Third Party Security and First Party Security have now largely crumbled, with dire consequences for landlords holding such Third Party Security. (See, Redback Networks, Inc. v. Mayan Networks Corp. ("Mayan").) [FN3] Because a standby letter of credit constitutes an independent guaranty of a tenant's obligations by the issuing bank, it is

literally Third Party Security and cannot be construed as First Party Security. [FN4] However, the courts have refused to let their section 502(b)(6) analysis stop there. Instead, post-bankruptcy, the courts now look through any traditionally independent letter of credit obligations and focus instead on whether a particular letter of credit was collateralized, pre-bankruptcy, by First Party Security. [FN5] When Third Party Security is backed by First Party Security, that type of Third Party Security (which is called in this article "Conduit Third Party Security") ***517** receives the same kind of treatment under section 502(b)(6) as does First Party Security, i.e., the debtor-tenant gets a credit against the landlord's section 502(b)(6) capped claim to the extent of any money or property the landlord receives from such Conduit Third Party Security and, to the extent the landlord is paid more than the landlord's section 502(b)(6) capped claim from the Conduit Third Party Security, the debtor-tenant may seek a refund from either the landlord or, perhaps, the bank-issuer of the letter of credit. [FN6]

As its stands, the whole notion of Conduit Third Party Security represents a considerable departure from prior bankruptcy case law, which consistently recognizes the independence principal in the context of both section 105(a) and section 362(a). [FN7] One intermediate court, however, has gone even further and, in AMB Property, L.P. v. Official Creditors Committee ("AMB"), announced a rule that gives the debtor-tenant a credit against the landlord's section 502(b)(6) capped claim on account of any

money or property the landlord receives from any type of security the landlord holds against tenant default, specifically including, but not limited to, Third Party Security in which the debtor-tenant never had any ownership interest ("True Third Party Security"). [FN8]

It is one thing to frustrate a landlord's use of a fully collateralized standby letter of credit based on a Conduit Third Party Security theory. It is a much more radical step to allow the debtor-tenant a credit against the landlord's section 502(b)(6) capped claim on account of any money or property the landlord receives from True Third Party Security. By finding such a broad right to a credit against the landlord's section 502(b)(6) capped claim, AMB necessarily destroys all of the guarantor's rights to subrogation and thereby awards the debtor-tenant a windfall. [FN9]

Fortunately for landlords, the unpublished AMB decision is unlikely to wind up representing the final word on True Third Party Security. Reassuringly, the even more recent Mayan decision expressly recognizes the inappropriateness of applying § 502(b)(6) to True Third Party Security, with Bankruptcy Judge Klein concluding in his concurring opinion that: "The bottom line is that landlords are permitted to obtain credit enhancements that will net them more than the § 502(b)(6) cap, but only so long as the excess does not come from [§ 541(a)] property of the estate." [FN10]

Most intriguingly, the Mayan decision opens up the question of whether ***518** it is possible for landlords to protect themselves

pre-bankruptcy from section 502(b)(6) post-bankruptcy. One likely alternative is for landlords to require that tenants procure a surety bond ("True Sale Surety Bond"), employing the securitization technique known as a "true sale," so as to convert ("securitize") what would otherwise be First Party Security (the bond premium) into True Third Party Security (the bond proceeds). [FN11] To facilitate the use of such a True Sale Surety Bond, the following lease language should be employed: [FN12]

Bankruptcy Remote Credit Enhancement.

As set forth below, and as a material inducement for Landlord to lease to Tenant, Tenant shall provide Landlord with a bankruptcy remote credit enhancement. Tenant agrees this bankruptcy remote credit enhancement does not, in and of itself, form all or any portion of any non-bankruptcy remote security deposit for its benefit.

Bond. Tenant, at its own sole cost and expense, shall obtain a bond in the face amount of [$blank] ("Bond") purchased by Tenant from a licensed surety insurance company rated at least "A-" in the then most current issue of Best's Insurance Reports or an equivalent rating service reasonably selected by Landlord ("Surety").

Form of Bond. The Bond shall be in a form reasonably acceptable to Landlord, in Landlord's sole discretion, and shall indicate thereon that it neither is, nor will be, collateralized by

any money or property of Tenant.

Landlord's Default Call. At any time following Tenant's default, Landlord, in Landlord's sole discretion, may call for the proceeds of the Bond (the "Default Call").

Tenant's Obligation to Keep Bond in Force. Tenant shall keep the Bond in force during the lease term and any failure by Tenant to keep the Bond in force during the lease term shall itself be a Tenant's default, entitling Landlord, inter alia, to make a Default Call.

Section 502(b)(6) robs the landlord's security of the predictability normally associated with cash, letters of credit and surety bonds. In response, ***519** landlords have three alternatives: (i) get True Third Party Security from solvent guarantors; (ii) limit themselves to leasing exclusively to true credit tenants; or (iii) use a True Sale Surety Bond. The first two choices are not always available to landlords. To the extent the third choice, the True Sale Surety Bond, now becomes available to landlords, its use should be seriously considered in every case. There is simply no reason securitization of First Party Security should not do for landlords what securitization has done generally for the financial markets -- effectively minimize the risk of a transferor's bankruptcy.

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[FN1]. For purposes of this article, "First Party Security" is defined as the money or property which the tenant pledges to the landlord to secure the tenant's performance under the lease. It is usually denominated a security deposit by the courts. See, Oldden v. Tonto Realty Corp., 143 F.2d 916 (2d Cir. 1944) ("Oldden"). "Third Party Security" is any pledge of another party's credit, whether or not that third party pledge is itself secured, in its turn, by any money or property from any source. Thus, an entirely unsecured guaranty from a third party which holds no reimbursement agreement from the tenant is still a type of Third Party Security as that term is used in this article. The distinction between First Party Security and Third Party Security is well recognized for purposes of 11 U.S.C. §§ 105(a), 362(a). See, e.g., O'Malley Lumber Co. v. Lockard (In re Lockard), 884 F.2d 1171 (9th Cir. 1989) (surety bond not subject to § 362(a)); see also McLean Trucking Co. v. Department of Indus. Relations (In re McLean Trucking Co.), 74 B.R. 820 (Bankr. W.D.N.C. 1987) (same); see also Advanced Ribbons & Office Prod., Inc. v. U.S. Interstate Distrib., Inc. (In re Advanced Ribbons & Office Prod., Inc.), 125 B.R. 259 (9th Cir. B.A.P. 1991) (same); see also Parkcenter Mall Associates v. Crown Life Ins. Co. (In re Parkcenter Mall Associates), 1991 Bankr. Lexis 999 (Bankr. D. Idaho 1991) (letter of credit not subject to either §§ 105(a), 362(a)); but see Wysko Inv. Co. v. Great Am. Bank, 131 B.R. 146 (D. Ariz. 1991) (§ 105(a) applies to letters of credit); see also In re Delaware River Stevedores, Inc., 129 B.R. 38 (Bankr. E.D. Pa.

1991) (same).

[FN2]. 11 U.S.C. § 502(b)(6) (limiting claims by nonresidential lessor in bankruptcy to one year's rent or 15% of overall rent not to exceed three years' rent). See Geoffrey L. Berman et al., Landlords Use Letters of Credit to Bypass the Claim Cap of § 502(b)(6), 2001 ABI JNL. LEXIS 222 (Dec. 2001). All further references are to the Bankruptcy Code [11 U.S.C. §§ 101 et. seq.].

[FN3]. Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.), BAP No. NC-02-1483-JRyK 2004 Bankr. LEXIS 184 (9th Cir. B.A.P. filed Feb. 5, 2004); see also Solow v. PPI Enters. (U.S.) (In re PPI Enters. (U.S.)), 324 F.3d 197 (3rd Cir. 2003) (hereafter "PPI"); see also Faulkner v. EOP-Colonnade of Dallas, LP (In re Stonebridge Techs., Inc.), 291 B.R. 63 (Bankr. N.D. Tex. 2003) (hereafter "Stonebridge"); see, generally, Daniel J. Carragher, Courts Limit Benefits to Landlords Under Letters of Credit, 2003 ABI JNL. LEXIS 126 (July 2003).

[FN4]. Kimberly S. Winick, Tenant Letters of Credit: Bankruptcy Issues for Landlords and Their Lenders, 9 AM. BANKR. INST. L. REV. 733 (2001).

[FN5]. Mayan states: "If the collateral would come back to the Debtor, but for the existence of the pledge of security, then it is

a security deposit for purposes of this analysis." In contrast, both PPI and Stonebridge rely on the fact the leases in both those cases recited that the letters of credit in question were given "in lieu" of security deposits. This latter analysis is very superficial. See, generally, Laura B. Bartell, The Lease Cap and Letters of Credit: A Reply to Professor Dolan, 120 BANKING L.J. 828 (October 2003).

[FN6]. The proposition that banks rather than landlords must make a refund in the context of over-funded letters of credit first comes in Bankruptcy Judge Klein's lengthy concurring opinion in Mayan, where he begins by asserting that the rationale for holding that the proceeds of letters of credit must be applied against the cap does not derive from Oldden. Rather, after first citing Justice Scalia's decision in United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988) as support for taking a holistic view of construing the Bankruptcy Code, Bankruptcy Judge Klein goes on to discuss, inter alia, §§ 502(b)(6), 502(e), 524(e), 542, and 553(a). The basic analysis is that § 502(b)(6) cannot be read as a cap on landlord's remedies because § 524(e) expressly validates landlords receiving more than the capped claim so long as the payment comes from someone other than the debtor-tenant. Instead, § 502(b)(6) must be read as a cap on the estate's liability because it disallows landlord's claims in excess of the cap. Any security deposit held by landlords for lease performance can be set-off under § 553(a) only to the extent of

the cap. Any excess security deposit held by landlords must be returned to debtor-tenants under § 542(b). Building on this logic, Bankruptcy Judge Klein notes that § 502(e) disallows claims under reimbursement agreements to the same extent the underlying creditor claims are disallowed. Once a bank-issuer's claim under a reimbursement agreement is disallowed, it may not be offset under § 553(a) and any excess Conduit Third Party Security held by the bank-issuer must be returned to debtor-tenants under § 542(b). Under this analysis, it is thus the bank-issuer, not the landlord, who bears the credit risk of an over-funded letter of credit. But see Stonebridge, in which it was the landlord who was ordered to make a refund to the debtor-tenant following payment of an over-funded letter of credit by the bank-issuer, and the bank-issuer was then permitted to recover on its Conduit Third Party Security by the Bankruptcy Court despite § 502(e).

[FN7]. See note 1, supra, and cases cited therein.

[FN8]. AMB Property, L.P. v. Official Creditors Comm. (In Re AB Liquidation Corp.), No. 03-00021 (N.D. Cal. Sept. 30, 2003), where it is said: "Although AMB's secondary sources analyzing security deposits do not define security deposits as inherently including letters of credit, it is noteworthy that secondary sources analyzing letters of credit (and their various forms and purposes) do equate them with other forms of security, including security deposits. See FRIEDMAN ON

LEASES, PRACTICING LAW INSTITUTE § 20.2 (1997) ("Occasionally, a tenant has delivered to a landlord a letter of credit as a form of security.") ... The lease reveals that the purpose and function of the letter of credit was to be the same as that of a security deposit-to secure AMB against the debtor-tenant's default."

[FN9]. Subrogation otherwise available under § 509(a) is destroyed (and the debtor-tenant thereby pays less than the cap and obtains a windfall) because there is nothing left for the guarantor to subrogate against once the guarantor's payment to the landlord is credited against the § 502(b)(6) capped claim. See also In re Agrownautics, Inc., 125 B.R. 350 (Bankr. D. Conn. 1991) (discussion of common-law rights of subrogation in bankruptcy cases). Finally, it should also be noted that allowing a debtor-tenant a credit against the landlord's § 502(b)(6) capped claim on account of any money or property the landlord receives from Conduit Third Party Security destroys subrogation just as surely as it destroys subrogation in a True Third Party Security case. However the hypothetical loss of subrogation is meaningless in a Conduit Third Party Security case, in that the guarantor always elects its rights under its reimbursement agreement pursuant to § 502(e)(1)(C) by waiving subrogation under § 509(a) in order to obtain repayment from its Conduit Third Party Security. There is also no windfall to the debtor-tenant in its being given a credit against the landlord's § 502(b)(6) capped claim based on the

landlord's receipt of what the court has already determined is the debtor-tenant's own money or property, albeit that this money or property was transferred to the landlord through a conduit.

[FN10]. Both AMB and Mayan are not yet through the appeals process and either or both these two cases may result in a Ninth Circuit Court of Appeals decision on the applicability of § 502(b)(6) to Conduit Third Party Security sometime in 2004.

[FN11]. Any transaction by which assets are successfully isolated from a transferor's subsequent insolvency is known as a true sale. See, Peter J. Lahny IV, Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation, 9 AM. BANKR. INST. L. REV. 815 (2001) at note 176. The key criteria for successfully accomplishing a true sale are that the transfer must be made without the transferor having recourse against the transferee on account of the transfer. See ibid., at 842-845; see also Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 AM. BANKR. INST. L. REV. 287 (2001) at notes 49 and 50 and cases cited therein. By structuring a surety bond guaranteeing the tenant's performance to the landlord in such a way as to eliminate any possible refund of monies paid for the surety bond by the tenant, one presumably accomplishes the true sale of the surety bond to the tenant for the landlord's

benefit. This, in turn, isolates the tenant's payment for the surety bond from the effect of any later debtor-tenant bankruptcy, including § 502(b)(6).

[FN12]. Mayan's basic holding is that § 502(b)(6) can be avoided only where the credit enhancement obtained by the landlord is not coming, directly or indirectly, at the expense of § 541(a) property of the estate. A letter of credit that is not collateralized by § 541(a) property of the estate would thus qualify as a § 502(b)(6) avoidance device in the same way that a surety bond not collateralized by § 541(a) property of the estate would qualify as a § 502(b)(6) avoidance device. Given the ubiquity of bank security interests in commercial lending transactions and the risk of refund imposed on banks issuing secured letters of credit for more than the cap, obtaining a letter of credit in lieu of a security deposit may prove less practicable than obtaining an equivalent surety bond. Finally, of course, underwriting criteria and pricing may disqualify many prospective tenants from obtaining effective credit enhancements for their landlords.

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