

Letters of Credit in Commercial Real Estate: A Primer

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It should come as little surprise that as the world becomes ever more interconnected so too does the international investment market. The United States commercial real estate market has been a major beneficiary of foreign investments over the last several years and, in turn, U.S. based sellers, lenders and landlords have had to recalibrate their due diligence procedures. One significant difference when dealing with foreign investment opportunities is the use of a Letter of Credit which will give assurance to the U.S. seller, lender or landlord that the foreign entity or individual has the sums of capital that it purports to have and that the capital is available for its stated purpose. While fairly simple in form, a Letter of Credit requires proper review and negotiation to ensure its effectiveness and this article will provide an understanding of its mechanics.

In the arena of commercial real estate, a Letter of Credit is most likely to arise in two contexts. Letters of Credit are primarily used in commercial leases, where the tenant and landlord have agreed that a Letter of Credit will be used in the place of, or in addition to, a security deposit. This allows the tenant to keep the capital on its books and available, if necessary, while providing proper assurances to the landlord that the account maintains sufficient funds should a default occur under the lease. Ultimately, the amount of the security deposit the tenant will be required to deliver at lease execution will be decreased based on the amount of the Letter of Credit, thereby reducing the overall cost to the tenant. The second instance in which a Letter of Credit may be used is in place of a guaranty in the real estate loan context, especially when construction or substantial renovations are involved. Here, the Letter of Credit will ensure that if the borrower should default, there will still be funds available for debt service payments or payments to contractors.

The primary advantage to the “beneficiary” (the holder of the Letter of Credit) of using a Letter of Credit is that the beneficiary has a direct agreement with a third party bank who is not a participant to the real estate transaction. In the event of a default, or other triggering event, the beneficiary may act



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in accordance with the transaction documents and draw on the Letter of Credit without any further input from the “applicant” (the opposite party whose account is drawn on) to the Letter of Credit. Letters of Credit are made irrevocable by the applicant giving the beneficiary full power to draw by the terms of the Letter of Credit. This provides the beneficiary assurance of funds in the event of applicant insolvency and even bankruptcy.

Given that the Letter of Credit is an agreement between the beneficiary and issuing bank, the majority of courts have held that the Letter of Credit is not a part of the bankruptcy estate. This is referred to as the “independence principle” and would permit a landlord to make draws as permitted by the lease even in the event of a tenant bankruptcy. Conversely, a security deposit would be considered a secured claim in a bankruptcy proceeding, and would be subject to the automatic stay as an asset of the bankruptcy estate. The landlord in this instance would be required to submit a proof of claim against the estate, which would be subject to a statutory cap. However, courts are split on the treatment of draws on the Letter of Credit as a credit against the cap, which would arise in the event the amount of the landlord’s damages exceed the amount available in the Letter of Credit. The majority opinion is that any amounts drawn on the Letter of Credit will be deducted from the statutory cap, thereby reducing the available claim the landlord could make against the bankruptcy estate for amounts in excess of the Letter of Credit. However, a decision from the 5th Circuit (*In Re Stonebridge Technologies, Inc.*, 430 F.3d 260), has held that the draw should not be counted against the cap, or be subject to the cap, specifically in the case where the landlord’s claim against the estate has not been filed. Therefore, if the amount available through the Letter of Credit exceeds the capped amount the landlord would be available to receive from the bankruptcy estate, then the landlord may make such draws and not be subject to the statutory cap. These factors, in addition to the creditworthiness of a prospective tenant should be considered when determining whether to use a Letter of Credit and the amount of the Letter of Credit.

There are some disadvantages to using a Letter of Credit. The first is cost, since the applicant will be required to pay a fee to the bank for issuing the Letter of Credit, thereby increasing the overall transaction costs. This fee is typically a percentage of the face value of the Letter of Credit. In addition, depending on the creditworthiness and financial solvency of the applicant, the issuing financial institution may also require significant secured collateral as a condition to issuing the Letter of Credit. This should be considered by both parties early in negotiations, factoring in, among other things, the creditworthiness of the applicant and the general size of the deal. Another disadvantage in the context of commercial leases is that cash is not readily available to the landlord in the event of a default, whereas a security deposit, even if segregated, would be held in the account of the landlord. Again, creditworthiness becomes a very significant consideration because, as stated above, a tenant bankruptcy could ultimately render the funds subject to the automatic stay.

The terms of a Letter of Credit will be dictated by governing documents such as a loan agreement or a lease agreement. In considering the methods of drawing on the Letter of Credit, it is important to draft the governing documents with sufficient specificity so that the language that will trigger a draw is unambiguous and clear to all parties. Once this triggering event occurs, the beneficiary may make a draw on the Letter of Credit by the presentment of the original Letter of Credit and supporting documents to the issuing bank. It should be noted that some banks accept presentment via facsimile and if the parties intend to operate as such, it should be specifically drafted into the Letter of Credit. Like the governing documents, the Letter of Credit should be clear as to the specific documents required to be presented and the exact language of the draw request. The number of supporting documents should be limited

to further reduce deficient draw requests, and can often be simply a certified statement from the beneficiary that the draw is in compliance with governing documents. This certified statement should be drafted on the letterhead of the beneficiary and should be similar in form to the following:

“I, *name and title*, hereby certify that I am authorized to execute this statement in my capacity as *title of Beneficiary*, and I further certify that this Beneficiary is authorized to draw on the enclosed Letter of Credit No. *XX* in accordance with the terms and conditions of the *name of underlying document* between *Applicant* and *Beneficiary* dated *xx/xx/xxxx*, pursuant to an *event of default* by *Applicant* has occurred as of the date hereof.”

This statement should be pre-negotiated and, to the extent applicable, included as an exhibit to the Letter of Credit to further assure that there will be no ambiguities at the time of a draw on the Letter of Credit.

Another issue that may arise when dealing with a Letter of Credit is that, similar to a promissory note, there is only one fully executed copy or original that must be held by the beneficiary in order to effect draws. It would be prudent for the issuing bank to have a pre-negotiated cancellation and termination agreement in the event that a Letter of Credit is lost or destroyed. This agreement should include a general clause that the Letter of Credit has been cancelled by the issuing bank and that both the applicant and beneficiary will indemnify the issuing bank against any resulting claims. The agreement should be executed by all parties and should also include affidavits from the applicant and beneficiary certifying that the Letter of Credit has been lost; has not been recovered despite a diligent search; and if found, the Letter of Credit will be immediately turned over to the issuing bank.

Finally, given that Letters of Credit are frequently used in transactions with foreign parties, the International Chamber of Commerce has developed two sets of guidelines to use as governing law. Standby Letters of Credit, as discussed above, are typically governed by the International Standby Practices (the “ISP 98”). These are frequently used in the leases and guaranties as they require a triggering event, such as an event of default, before becoming payable. Conversely, commercial Letters of Credit are governed by the Uniform Customs and Practices for Documentary Credits (the “UCP 600”) and are most commonly used for trans-oceanic shipments of goods but can also be used in real estate purchase and sale agreements, especially those involving foreign purchasers. It is also prudent to include the UCC laws of a chosen state to govern all matters not addressed in either the UCP 600 or ISP 98.