

BENEFICIARIES BEWARE:
STANDBY LETTERS OF CREDIT ARE NOT BULLET PROOF

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Many believe that standby letters of credit are “better than cash.” Now, because of the turmoil in the financial services sector, beneficiaries of standby letters of credit issued by FDIC-insured banks in receivership are learning the hard way that these instruments may be worthless. Standby letter of credit beneficiaries should review their documents and take immediate action to ensure that they have the protections they expected.

Letters of credit play a key role in a variety of real estate transactions. For example:

- Landlords accept letters of credit as security deposits for leases
- Mortgage lenders require letters of credit as collateral for commercial mortgage debt
- Letters of credit are often used as earnest money deposits for real estate purchase and sale transactions
- Letters of credit are often provided to municipalities as security for bonding obligations

Many market participants view letters of credit as the equivalent of cash – and in some cases, even better than cash. For example, commercial landlords have long assumed that a letter of credit is preferable to a cash security deposit because of case law arising out of tenant bankruptcies that limits landlord access to these deposits.

Letters of Credit Can Become Worthless

The deep and prolonged crisis in the financial services industry will result in numerous FDIC-insured banks facing receivership or conservatorship. **Undrawn letters of credit issued by these institutions are likely to be worthless.** Parties to letter of credit transactions are advised to look carefully at their letters of credit and related documentation and enforce their right to require certain letters of credit to be replaced or, where possible, revise documents to require replacement of letters of credit issued by troubled institutions. At the end of this Alert, we have provided several suggested courses of action.

About Letters of Credit

The parties to a letter of a credit are as follows:

Issuer – the bank or thrift issuing the letter of credit is the Issuer.

Account Party – the party who obtains the letter of credit from the Issuer is the Account Party. Often, the Account Party arranging for a standby letter of credit delivers cash or other collateral to the Issuer to secure repayment of any draws on the letter of credit.

Beneficiary – the party who holds the standby letter of credit and who is authorized to draw under the letter of credit on the conditions stated in the letter of credit is the Beneficiary.

A standby letter of credit is issued by the Issuer to the Beneficiary at the request of the Account Party, and requires the Issuer to pay a specified sum to the Beneficiary upon satisfaction of the conditions of drawing specified in the standby letter of credit. The standby letter of credit will specify the maximum amount that may be drawn, the expiration date, the place where drafts must be presented and what certifications or deliveries must be made in connection with the draw request. Virtually all letters of credit utilized in real estate transactions are “sight draft” letters of credit, which means that the Beneficiary can require payment under the letter of credit upon delivery of a simple sight draft, which looks very much like a bank check, together with any other required certifications.

Letters of credit are governed by Article 5 of the Uniform Commercial Code (the “UCC”), which has been enacted in every state and the District of Columbia. In addition, parties generally agree that the letter of credit will be governed by the Uniform Customs and Practice for Documentary Credits (the “UCP”) or the International Standby Practices 98 (the “ISP”), both of which are promulgated by the International Chamber of Commerce. Standby letters of credit issued by US financial institutions are also subject to regulation by one or more of the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Federal Reserve Board and the Office of the Comptroller of the Currency.

Standby letters of credit are generally issued and held pursuant to a separate contract between the Account Party and the Beneficiary – such as a lease, loan agreement, purchase agreement or public improvement agreement. The “underlying contract” between the Account Party and the Beneficiary is separate and independent of the letter of credit as a legal matter, but it will specify the requirements that the letter of credit must satisfy and when it can be drawn. If these documents are drafted properly, they will generally contain language that requires the Issuer to meet certain specified standards as to its financial strength.

Following is some typical lease language (although any actual language you use should be crafted to fit the particular case):

The Letter of Credit shall be issued by a commercial bank acceptable to [Landlord] and (1) that is chartered under the laws of the United States, any State thereof or the District of Columbia, and which is insured by the Federal Deposit Insurance Corporation; (2) whose long-term, unsecured and unsubordinated debt obligations are rated in the highest category by at least two of Fitch Ratings Ltd. (Fitch), Moody’s Investors Service, Inc. (Moody’s) and Standard & Poor’s Ratings Services (S&P) or their respective successors (the Rating Agencies) (which shall mean AAA from Fitch, Aaa from Moody’s and AAA from Standard & Poor’s); and (3) which has a short term deposit rating in the highest category from at least two Rating Agencies (which shall mean F1 from Fitch, P-1 from Moody’s and A-1 from S&P) (collectively, the LC Issuer Requirements). If at any time the LC Issuer Requirements are not met, or if the financial condition of such issuer changes in any other materially adverse way, as determined by [Landlord] in its sole discretion, then [Tenant] shall within [five (5)] days of written notice from [Landlord] deliver to [Landlord] a replacement Letter of Credit which otherwise meets the requirements of this [Lease] and that meets the LC Issuer Requirements (and [Tenant]’s failure to do so shall,

notwithstanding anything in this [Lease] to the contrary, constitute an Event of Default for which there shall be no notice or grace or cure periods being applicable thereto other than the aforesaid [five-day] period). Among other things, [Landlord] shall have the right under such circumstances to immediately, and without further notice to [Tenant], present a draw under the letter of credit for payment and to hold the proceeds thereof.

Following is some typical language for the governing documents (and once again, any actual language you use should be crafted to fit the particular case):

In the event the issuer of any letter of credit held by [Landlord] is insolvent or is placed into receivership or conservatorship by the Federal Deposit Insurance Corporation, or any successor or similar entity, or if a trustee, receiver or liquidator is appointed for the issuer, then, effective as of the date of such occurrence, said Letter of Credit shall be deemed to not meet the requirements of this Section, and then [Tenant] shall within [five (5)] days of written notice from [Landlord] deliver to [Landlord] a replacement Letter of Credit which otherwise meets the requirements of this [Lease] and that meets the LC Issuer Requirements (and [Tenant]'s failure to do so shall, notwithstanding anything in this [Lease] to the contrary, constitute an Event of Default for which there shall be no notice or grace or cure periods being applicable thereto other than the aforesaid [five-day] period); or, alternatively, [Tenant] shall, within such [five-day] period deliver cash to [Landlord] in the amount required above.

Letters of credit typically follow a fairly pre-determined format. However, the Issuer will often agree to include customized language which might include, among other things, the Beneficiary's automatic right to draw in the event the letter of credit is due to expire without being renewed or replaced, or if the Issuer's credit rating drops below a specified level.

It is obvious that a Beneficiary is in a much better position if it draws upon a letter of credit for payment, and retains the proceeds, *before* the Issuer is subject to a receivership or conservatorship order by FDIC. Failure to do so could render the letter of credit worthless and leave the Beneficiary without a viable course of action to re-establish the deposit or other security.

While beyond the scope of this article, the type of account in which the proceeds are held, in the case of a tenant security deposit, should be carefully considered in order to minimize potential bankruptcy risks.

FDIC May Repudiate Letters of Credit from Banks in Receivership

US banks and thrifts are failing at an alarming pace, and the Rating Agencies have dramatically downgraded the credit ratings for numerous institutions whose financial strength would have been unquestioned just a year or two ago. For banks, 2008 was a very painful year. In 2007, only three banks were placed into receivership; last year, 25 failed, an increase of more than 800 percent.

This year, 2009, is looking ominous for the banking industry, and many experts predict that large

numbers of banks and thrifts will be placed under government control throughout the year. Meanwhile, the Rating Agencies will downgrade ratings as institutions' prospects dim. While the government agencies often transfer assets and liabilities of a failed institution to a successor, the government has the statutory right to repudiate all "burdensome" contracts – including letters of credit – when it places a bank or thrift under government control.

FDIC has recently reminded letter of credit Beneficiaries – most notably commercial landlords – that **FDIC may not honor undrawn standby letters of credit issued by banks that have been placed under government receivership or conservatorship**. In other words, the FDIC has announced that it can repudiate undrawn letters of credit, and that no damages against the Issuer will be available to the Beneficiary, unless the conditions for drawing were fully satisfied before the receivership or conservatorship occurred. Because the United States Supreme Court has held that letters of credit are typically not deposits, the **Beneficiary is not protected up to the FDIC insurance limit for deposit accounts** – currently \$250,000 – if a letter of credit is repudiated. Letters of credit can, of course, be assumed by any bank that accepts the obligations of a failed institution, but the critical message here is that this may occur at the sole discretion of the FDIC and the acquiring bank. FDIC has wide latitude in the way it structures the transfer of assets of a failed institution, so even if a failed bank "merges" into a healthy institution, letters of credit may still be at risk.

Meanwhile, in the event the Issuer is placed under FDIC control, any cash deposited with the Issuer by the Account Party as collateral for a letter of credit will likely be considered a deposit account that is insured only up to \$250,000.

What to Do If You Are a Letter of Credit Beneficiary

First, check all agreements between you and the Account Party to identify the requirements that the standby letter of credit and the Issuer must satisfy.

Second, frequently check all standby letters of credit you may be holding to confirm maturity dates, conditions for draws and, most importantly, the identity of the Issuer. To determine whether the Issuer meets the standards appearing in your agreements with the Account Party, you can easily check the ratings on the rating agencies' websites, as applicable – www.standardandpoors.com; www.moody.com, and www.fitchratings.com. If it appears that the Issuer's rating has fallen below the specified standard, consider advising the party who is required to maintain the letter of credit of such failure in light of its contractual duties. Be sure to follow the document's notice requirements, and check the default provisions to determine whether the party is entitled to notice and a right to cure. FDIC does not publish its *FDIC Watchlist*; if you have concerns about any particular institution, please note it is unlikely the FDIC will either confirm or deny that institution's status.

A notice to a tenant might provide as follows:

Dear Tenant:

In accordance with the requirements of Section ___ of the Lease dated ____, by and

between ABC, LLC (“Landlord”) and XYZ, Inc. (“Tenant”), _____ Bank, the issuer of the letter of credit required under your Lease, no longer meets the LC Issuer Requirements specified therein. Accordingly, pursuant to the requirements of the Lease, Tenant has [five (5)] days from the date of this letter to deliver a replacement letter of credit from a bank that meets such requirements, failing which, Landlord has the right to present the existing letter of credit for payment and to hold the proceeds pursuant to your Lease.

Very truly yours,

[Landlord]

Third, as noted above, many standby letters of credit permit a drawing in full in the event that the Issuer fails to meet the requirements of the underlying contract and no replacement letter of credit has been delivered within a specified time period. When a Beneficiary holds a standby letter of credit with such language, the beneficiary should consider presenting a draw before the Issuer is placed under receivership or conservatorship. Look carefully at notice and cure provisions in the underlying document (such as the lease), and the letter of credit itself, to ensure that no liability will arise from such an action. Under applicable law, the Issuer may have as long as five business days to honor a draft for payment, so **quick and decisive action** will be imperative.

Fourth, in some instances, letters of credit are held in an escrow arrangement by a title company, bank or other entity. Because you should never assume that the escrow agent will be monitoring the Issuer’s financial condition (even if the escrow holder has agreed to do so), **review the applicable terms and conditions** to ensure that the appropriate protections are in place.

Fifth, to the extent that you are involved in documenting a new transaction, **review carefully** how the letter of credit provisions in your documents work, and be mindful of the fact that bank ratings can change dramatically in the course of a day. In addition, from a drafting standpoint, counsel will want to ensure that the documents do not grant back-to-back notice and grace periods that could make decisive action impossible. A tenant may be unable, as a practical matter, to replace a repudiated letter of credit if the Issuer is subject to a receivership or conservatorship action and the FDIC does not transfer the Issuer’s obligations to a successor bank.

Conclusion

Letters of credit play an important role in a variety of real estate and other commercial transactions. The documents associated with the letter of credit, and the letter of credit itself, need to be drafted in a way that recognizes the current volatility in the financial markets. While most documentation will work as the parties intended, increased vigilance is imperative until the banking industry stabilizes.