

**LETTERS OF CREDIT IN SALE AND LEASEBACK TRANSACTIONS:
ONE SIZE DOES NOT FIT ALL¹**

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A standby letter of credit, serving as a security deposit to secure the obligations of a lessee, is one of the most useful protections a landlord can obtain, particularly in the event of the lessee's bankruptcy and subsequent rejection of the lease.² In evaluating the protection afforded by the standby letter of credit, however, landlords and lenders need to be aware of a recent case out of the Eleventh Circuit, which determined that, under certain circumstances, a beneficiary might be able to draw on the letter of credit, but not keep all of the proceeds. In *Two Trees v. Builders Transport, Inc.* (*In re Builders Transport, Inc.*), --- F.3d ---, WL 3490844 (11th Cir., Dec. 5, 2006), the Eleventh Circuit Court of Appeals, affirming the bankruptcy court and district court below, ordered the turnover of the proceeds of a \$1.6 million standby letter of credit to the extent that the proceeds exceeded the proven lease rejection damages. The decision of the Court of Appeals sounds a warning in the context of sale and leaseback transactions: If the letter of credit is meant to secure the lessee's lease obligations and the landlord's mortgage obligations, then such intention had better be explicit.

As discussed in greater detail below, in *Builders Transport*, the landlord, Two Trees, had borrowed funds from CIT Group/Business Credit, Inc. ("CIT") to purchase from the Debtor certain real estate, which it leased back to the Debtor. The

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² The Fifth Circuit Court of Appeals in *EOP-Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Tech.)*, 430 F.3d 260 (5th Cir. 2005) held that the Section 502(b)(6) cap on lessor's damages was not an avoidance power and is triggered only upon the lessor's filing of a claim against the estate. The lessor in *Stonebridge* was therefore permitted to retain the proceeds of a standby letter of credit in excess of the statutory cap on damages.

standby letter of credit served as the lessee/Debtor's security deposit as part of that sale and leaseback transaction with Two Trees. After the Debtor's chapter 11 filing and contemporaneously with the lease's stipulated termination, the letter of credit was drawn down in full by CIT, as the assignee of the landlord's interest. The Debtor then commenced a turnover action pursuant to section 542(a) of the Bankruptcy Code to recover the proceeds of the letter of credit in excess of the allowable lease rejection damages. The bankruptcy court found for the Debtor, and the district court affirmed..

The Eleventh Circuit affirmed as well. The court held that the distributed proceeds of the standby letter of credit were property of the estate, notwithstanding the arguments to the contrary under a number of theories. The court found that although the distribution to a beneficiary under a standby letter of credit was outside of the bankruptcy process, the beneficiary's right to retain the full amount of such proceeds was governed by the rights established in the underlying documents – the lease and the standby letter of credit itself. Because the underlying documents made it clear that the letter of credit was intended to backstop only the lease, not the mortgage between CIT and the landlord, the court found that after a credit for the landlord's proved damages, the Debtor's estate was entitled to recovery of the net proceeds of the letter of credit.

The *Builders Transport* court reached the correct result. If the landlord and mortgagee, as its assignee, wanted the letter of credit to secure not only the lease obligations of the Debtor, but also the mortgage obligation of the landlord, the parties would have and could have said so explicitly. Instead, all of the underlying documents evince a clear intention for the letter of credit to secure the lease obligations only.

The appellant argued that because the lease was a secured financing rather than a true lease, section 502(b)(6) statutory cap on lessor damages was inapplicable and it could therefore retain the full proceeds of the letter of credit. The Eleventh Circuit did not accept that argument, and instead focused on whether the letter of credit meant to secure something more than the Debtor's obligations under the lease. The court upheld the bankruptcy court's decision that answered the question in the negative, and effectively issued a warning to parties involved in a sale and leaseback transaction – if a standby letter of credit is meant to secure more than just the lease obligation, that intention must be clearly stated in the documents.

THE FACTS OF *BUILDERS TRANSPORT*

THE SALE AND LEASEBACK AND THE STANDBY LETTER OF CREDIT

In *Builders Transport*, the Debtor owned certain real property in Camden, South Carolina. In 1995, the Debtor, in order to take advantage of certain capital loss carryforwards that remained unused, entered into a sale and leaseback transaction with Two Trees. Under the deal, Two Trees bought the property from the Debtor for \$3.5 million and then leased it back to the Debtor. The lease term was for five years, with the Debtor having the option of renewing the lease for four successive periods of five years at the prevailing fair market rental rate. Following the closing, the Debtor's board of directors ratified the transaction and approved the issuance of a standby letter of credit to secure the Debtor's obligation to Two Trees under the lease. Dai-Ichi Kangyo Bank (the "Bank") issued a letter of credit in favor of Two Trees, in the amount of \$1.6 million, to support the Debtor's "obligation to pay rent and other amounts under the lease."

Two Trees borrowed the money to purchase the property from CIT, which at that time was also the Debtor's primary lender. The loan was secured by a first mortgage against the Camden property and with an assignment to CIT of Two Tree's interest in the lease agreement and the letter of credit. Rent payments made by the Debtor went directly to CIT pursuant to a lockbox agreement between CIT and Two Trees. While the amount of the monthly lease payment was equal to the amount of the mortgage note payment, the court noted that, had the mortgage note been amortized according to the lease terms, Two Trees would have owed CIT in excess of \$2 million at the end of the 5-year lease term.

Finally, CIT was obligated to reimburse the Bank for payment made by the Bank on account of the letter of credit. In turn, pursuant to the terms of the separate financing agreement between CIT and the Debtor, CIT was permitted to add the reimbursement amount to the Debtor's secured line of credit as an expense under the lease. .

DRAWDOWN ON THE LETTER OF CREDIT AND THE TURNOVER ACTION

The Debtor filed its chapter 11 case in May of 1998, and in July of 1998, the Debtor conducted a public auction of certain parts of its business. Also in July, CIT as the assignee of Two Trees' interest in the lease and letter of credit, notified the Bank that the Debtor's obligations under the lease had been accelerated and submitted a default draft to the Bank for \$1.6 million. The Bank paid the full amount of the letter of credit to CIT, and CIT then reimbursed the Bank for the full amount and then charged that amount to the Debtor's line of credit. Ultimately, CIT used the \$1.6 million to pay down Two Trees' debt to it under the mortgage note.

Following the auction and the closing of the sale of its business to a third party, the Debtor entered into a termination agreement with CIT. That agreement set forth the amount of the secured claim of CIT, and included the \$1.6 million charge to the Debtor's line of credit on account of the letter of credit reimbursement.

The Debtor then commenced an action pursuant to section 542(a) of the Bankruptcy Code, seeking the turnover of that portion of the \$1.6 million in proceeds of the standby letter of credit that exceeded the provable damages under the lease (subject to the section 502(b)(6) statutory cap). The turnover complaint alleged, among other things, that the proceeds in excess of the provable and allowable lease damages were property of the Debtor's estate.

The bankruptcy court found for the Debtor and entered a judgment in favor of the Debtor in the amount of \$1,175,995.44 (the net proceeds of the letter of credit after deduction of the proven damages under the lease). That decision was affirmed by the district court, and was appealed to the Eleventh Circuit court of appeals.

THE LETTER OF CREDIT AND THE COMMON LAW INDEPENDENCE DOCTRINE

The Eleventh Circuit held that the proceeds of the letter of credit were property of the Debtor's estate and thus recoverable under section 542(a). The court disagreed with the argument that, because the letter of credit was an obligation between the Bank and Two Trees, the common law doctrine of independence exempted the proceeds from being part of the property of the Debtor's estate. The court held that the doctrine was inapplicable, because the Debtor was not challenging the distribution to the assignee, but rather the assignee's right to retain the distribution. In other words, the

doctrine of independence protects the actual distribution of the proceeds, but it does not vitiate the obligations under the underlying contracts.³

The court also held that, because under South Carolina law, as is the case with most state law, an implied covenant of good faith and fair dealing is part of any contract, the underlying lease agreement and standby letter of credit imposed a duty to return the excess proceeds of the letter of credit that were not used to secure the Debtor's obligations under the lease. Because the Debtor's estate had an interest in the proceeds of the letter of credit held by the assignee by virtue of its common law rights under South Carolina law, the court found that the Debtor was entitled to seek a turnover of the proceeds under section 542(a).

**THE RECHARACTERIZATION OF THE LEASE AS A SECURED FINANCING:
FORM OF TRANSACTION IS IRRELEVANT IN TURNOVER ACTION**

The appellant next argued that the lease transaction should be treated as a secured financing rather than a true lease, and that therefore the letter of credit should be seen as a means to make up the difference between the actual value of the property and the mortgage. In this way, according to the appellant, the statutory cap on lessor damages under section 502(b)(6) is irrelevant and does not alter the assignee's ability to retain the entire proceeds of the letter of credit.

The court held that in a section 542 turnover action, the relevant question is whether the third party has a right under the terms of the underlying agreements to the proceeds of the letter of credit – regardless of whether it is a true lease or a secured

³ The Court distinguished its finding that the letter of credit proceeds were property of the estate from its holding in *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 296 (11th Cir. 1988) wherein it held that the letter of credit and its proceeds were not property of the estate. The earlier case involved a claim by a creditor with regard to its proper receipt of proceeds of a letter of credit under a section 547(b) preferential transfer analysis and did not address as in *Builders Transport* the claim of a debtor to proceeds improperly retained pursuant to section 542 action.

financing. In this vein, the court examined the lease agreement and the letter of credit and found that the unambiguous language of both supported a finding that under South Carolina law, the Debtor was entitled to turnover of the letter of credit proceeds retained by the assignee in excess of the proved lessor damages. The court also found that, even if the terms of the lease and letter of credit were somehow ambiguous, the evidence in the record did not yield a different result. This was so for three reasons: (a) the Debtor never executed the mortgage and was not liable under the mortgage; (b) the Debtor never guaranteed the debt under the Two Trees mortgage; and (c) the Debtor never executed any agreement under which it agreed to pay the amount that Two Trees owed to CIT under the mortgage.

The court also dispensed with the appellant's final argument that the letter of credit was meant to secure the landlord's mortgage obligation to CIT. The court again relied on the absence of any language in the lease or letter of credit that evidenced an intention for the letter of credit to secure anything other than the lease obligation. By way of illustrating the logic of its finding, the court noted that, if the Debtor had performed fully its obligations under the lease for the entire 60-month term, a period of time that is considerably shorter than the amortization period under the mortgage, there would be no letter of credit, because the lease would not have been breached, yet the mortgage obligation would have remained.

Ultimately, the lack of specificity in the underlying agreements concerning the intention of the parties to have the letter of credit secure both the lease and mortgage obligations was fatal to the assignee's attempt to link the two separate obligations to the letter of credit. And because the underlying agreements evidenced that the letter of credit

was only intended to secure the lease obligation, the assignee could only retain the amount of letter of credit proceeds that satisfied that obligation.

SECTION 502(b)(6) CAP ON DAMAGES IS INAPPLICABLE IN A TURNOVER ACTION

Finally, the court held that section 502(b)(6) was inapplicable, since the undisputed amount of lessor damages was in fact less than the section 502(b)(6) statutory cap. The basis for the Debtor's challenge was not that the retained proceeds of the letter of credit exceeded the statutory cap, but rather that the assignee/mortgagee was not entitled to retain anything other than damages relating to the lease, pursuant to the underlying agreements.

Under applicable South Carolina law, lessors are entitled to claim special damages, defined as "those that may reasonably be supposed to have been in the contemplation of both parties at the time of contracting as a probable result of the breach." The assignee could not prove any special damages under the lease, because it ultimately was unable to bootstrap the mortgage indebtedness as additional damages under the lease. Thus, according to the court, the appellant's lessor damages did not and could not under the plain language of the agreements include the mortgage debt.

DISTINGUISHING STONEBRIDGE

In *dicta*, the court distinguished its holding, that the section 502(b)(6) cap was inapplicable because the assignee was not entitled to retain the funds pursuant to the terms of the underlying agreement, from that of the Fifth Circuit court of appeals in *Stonebridge*. In *Stonebridge*, the court held, among other things, that the filed claim of a lessor was a precondition to applying the damages cap under section 502(b)(6), and that the debtor did not have any common law actions against the lessor pursuant to the lease.

Stonebridge, 430 F.3d at 274. The *Builders Transport* court commented that, unlike the Debtor in *Stonebridge*, the Debtor in its case had a common law action against the appellants based on the unlawful retention of the letter of credit proceeds. Moreover, the court reiterated that the damages cap never came into play because lessor damages were less than the cap. The court was therefore not required to address the applicability of the statutory cap, because neither the Landlord nor its assignee filed a claim against the estate and because actual lease damages were less than the cap.

CONCLUSION

In structuring sale and leaseback transactions with standby letters of credit as a component, practitioners are advised to heed the *Builders Transport* court's warning: If the letter of credit is meant to secure the obligations under the lease **and** the underlying mortgage, such an intention must be clear and unambiguous. Beneficiaries of a standby letter of credit simply cannot rely on the interrelatedness of the sale and leaseback and assume that the letter of credit secures losses under both the lease and the mortgage. In order to avoid the result in *Builders Transport*, the original transaction documents signed by the lessee and the landlord/borrower should explicitly state that the letter of credit secures both the lease and the mortgage obligations. Alternatively, a mortgagee who is assigned the mortgagor/lessor's interest in a letter of credit may wish to require that the lessee/debtor guarantee the mortgage obligation to the extent of the standby letter of credit or ensure that the letter of credit itself is issued to secure both obligations. Anything short of such an explicit statement of intention could leave the assignee without full recourse to the proceeds of the letter of credit.