LEASING AND FINANCING

Supplying a letter of credit as security under a commercial lease is a mere three-party affair involving the landlord, tenant, and letter of credit issuer. When the landlord’s lender also gets involved, the complexities can grow swiftly and exponentially. This article addresses these complexities as well as functional and legal advantages of a letter of credit relative to other forms of security from the perspective of the landlord’s lender. The article guides the lender (and its counsel) through issues related to a tenant letter of credit, including obtaining an acceptable form of letter of credit, advantageous lease provisions, and obtaining an effective assignment of rights and proceeds under a letter of credit. Enforcement and bankruptcy concerns are also covered. Sample forms of a letter of credit and a landlord-lender agreement are included.

Tenant Letters of Credit: Satisfying the Landlord’s Lender

Mortgage lenders have a strong interest in the success of the tenants of their commercial borrowers, whose rental payments provide the stream of income necessary for the landlord-borrower to service the mortgage loan. Therefore, lenders often have a comparable interest in any credit enhancements that a landlord obtains from its tenant, and often require additional security as proof of a tenant’s credit quality. This article will focus on letters of credit as one of the types of tenant credit enhancements available to commercial landlords, and the interplay of the various interests of the lender, the landlord, the tenant, the issuer of the letter of credit, and other parties.

Traditionally, a commercial tenant may provide assurances of its creditworthiness and ability to perform under a commercial lease in the form of a cash security deposit or a guaranty by a strong parent or other creditworthy affiliate. While such assurances have certain advantages, each possesses inherent practical and legal disadvantages that limit its value to the landlord and, by extension, to the landlord’s lender.

In the case of cash security deposits, the only effective manner in which the landlord’s lender may obtain an assignment of a security deposit is to direct the landlord to segregate an amount equal to the security de-

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The guaranty also has certain disadvantages. Its value to the lender may diminish or evaporate in the case of the insolvency or bankruptcy of the guarantor, and, in any event, a guaranty may require litigation to be enforced. In addition, if the guarantor becomes a debtor in a bankruptcy proceeding, the landlord’s action to enforce the guaranty is subject to the automatic stay provisions of the Bankruptcy Code, and the landlord may find itself holding an unsecured contingent claim of limited value. Also, the guarantor of a bankrupt tenant may assert that its guaranty liability is limited by the cap on the underlying liability of the tenant under Section 502(b)(6) of the Bankruptcy Code.1

For these reasons, landlords and their lenders favor a simple letter from a creditworthy third party that is callable for cash on sight—sometimes referred to as a letter of credit or standby letter of credit. A letter of credit obtained by the tenant can provide the virtual equivalent of cash, and protection against a tenant bankruptcy. This article will discuss some of the practical, functional, and legal advantages of a letter of credit from the perspective of the landlord’s lender, and will make suggestions for a practical assignment of the benefits of a letter of credit by the landlord-borrower to the lender.

Nature of the Letter of Credit. Fundamentally, the purpose and rationale behind a letter of credit is to bolster or substitute the creditworthiness of any party, sometimes referred to as the “applicant” or account party, with the creditworthiness of a bank or other creditworthy third party, sometimes referred to as the “issuer,” in connection with some obligation owed to a third party, the “beneficiary.”2 Generally, there are two types of letters of credit:

(a) The “documentary” letter of credit has been used for centuries to facilitate trade among countries and distant merchants.3 It is used in much the same way to-for centuries to facilitate trade among countries and such funds may not be fully available to the landlord (or to the landlord’s lender).

(b) The “standby” letter of credit functions differently: it serves as a guaranty of the account party’s obligations to the beneficiary by the issuer of the letter of credit, rather than as a source of payment. A standby letter of credit is an assurance of payment, and can be drawn upon by the beneficiary only if the account party fails to meet certain pre-defined obligations owed to the beneficiary.4

With both types of letter of credit, the issuer agrees to pay money against a specified document or documents that accompany the request for payment. The presentation required under a standby letter of credit may merely be the request for payment (typically a “sight draft”), although other documents may be required. As used in this context, the term “sight” means that payment is to be made at the time of presentation, rather than a “deferred payment,” which means payment at a later time. (A typical form of sight draft is attached as Schedule 1 to Appendix A to this article.)

In the commercial leasing context, the landlord or the landlord’s lender may require a tenant of uncertain creditworthiness to provide a letter of credit issued by the tenant’s bank. In the event that the tenant defaults on some material obligation under the lease, the landlord or the landlord’s mortgage lender may draw upon the letter of credit. It goes without saying that if the tenant meets its obligations under the lease, the beneficiary (whether the landlord or lender) would not draw upon the letter of credit and would allow termination or expiration of the letter of credit.

Letters of credit are especially useful when a prospective tenant lacks a substantial net worth, such as a high-tech start-up tenant that requires significant space to operate. The tenant obtains the letter of credit by paying a fee and (in most cases) providing some collateral to the issuing bank, and provides the letter of credit to the beneficiary. The bank (or other institution that issues the letter of credit) promises to pay the beneficiary upon presentation of a simple draw request (or, less preferably, on notice of a condition such as the occurrence of a tenant default). The tenant does not need to approve the draw or agree that a default has occurred. The fundamental premise is that the landlord or lender is free of the tenant’s credit risk because it has substituted the independent obligation of the issuer. The letter of credit is not property of the tenant (the tenant has no right to draw upon it); the issuer’s payment also is not property of the tenant because the issuer pays a draw from its own funds. As will be seen, this is significant in the bankruptcy context.

While the tenant also typically executes an agreement to reimburse the issuer if the letter of credit is drawn upon, that is a separate obligation and does not change the foregoing principles. While a standby letter of credit functions somewhat like a guaranty, such a letter of credit itself does not create a suretyship.5 The issuer’s obligation to pay is a primary, not a secondary, obligation; the tenant is not bound for the principal debt and its engagement (including any obligation to reimburse the issuer) is independent of it.6

Laws and Customs Governing Letters of Credit. Letters of credit are governed by a myriad of varying bodies of law, custom, and practice. The interplay between the basic tenets of letters of credit, such as the “indepen-

1 See “Bankruptcy Considerations” below.
2 “Beneficiary” is defined in Section 5-102(a)(3) of the UCC as “a person who under the terms of a letter of credit is entitled to have its complying presentation honored.” See U.C.C. § 5-102(a)(3) (2010).
5 CRM Collateral II, supra note 4, at *14.
6 See id., at *27.
dence principle” (discussed below) dating back to the first use of the letter of credit, to the Uniform Commercial Code (“UCC”), and modern international practice and customs, makes this time-tested credit enhancement unique.

Article 5 of the UCC is entitled “Letters of Credit” and is entirely devoted to these instruments. A “letter of credit” is defined in Section 5-102(a)(10) as “a . . . definite undertaking . . . by an issuer to a beneficiary at the request of or for the account of an applicant . . . to honor a documentary presentation by payment or delivery of an item of value.”

An important provision is the long-established “independence principle,” codified in Section 5-103(d) of the UCC, which states that the issuing bank must honor a letter of credit independently of any other contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

The issuer has no duty or obligation to determine whether a default in the underlying obligation actually exists. Thus, while the tenant may dispute the existence of a default, by virtue of the independence principle, the issuer is nonetheless obligated to honor the draw request. Further, in a properly structured transaction, a bankruptcy trustee for the tenant cannot invoke the automatic stay, apply the lease rejection cap applicable to security deposits under the Bankruptcy Code, or otherwise prevent the issuer from paying the letter of credit proceeds to the beneficiary. These issues will be more fully discussed below.

Under Section 5-108(a) of the UCC, an issuer shall honor a presentation that appears on its face “strictly to comply” with the terms and conditions of the letter of credit. This requirement of strict compliance has tripped up many landlords and lenders who are rightful lessors or creditors, respectively, but fail to submit the requisite documentation and/or certifications required under a letter of credit for a draw thereon. Unlike many other areas of law, under the UCC substituted performance or “functional alternatives” are not effective.

Custom within the banking industry also plays a role in governing letters of credit. Pursuant to Section 5-108(e) of the UCC, “[a]n issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer’s observance of the standard practice is a matter of interpretation for the court.” As a guide to standard practice, and in conjunction with the UCC, there are two generally accepted sources for letter of credit practice. The first is the ICC Uniform Customs and Practice for Documentary Credits (2007 Revision), International Chamber of Commerce Publication No. 600 (the “UCP”); the second is the International Standby Practices promulgated by the International Chamber of Commerce (the “ISP98”). Both provide guidance on such matters as how long an issuer is afforded to examine documents and either pay or reject a draw on a letter of credit, and the standards with which a presentation must comply.

In the event of a draw upon the letter of credit, the issuer will invariably require reimbursement in some form. Pursuant to UCC Section 5-108(d), the issuer has a statutory right to be reimbursed by the applicant “in immediately available funds not later than the date of [the issuer’s] payment of funds,” but a longer period is permitted if the UCP or ISP98 are incorporated into the letter of credit. In addition, as a matter of practice applicants almost always are required to execute written reimbursement and indemnification agreements in favor of the issuer. The applicant and issuer may mutually agree on the terms of reimbursement in these agreements.

Importantly, UCC Section 5-116(c) provides that in certain cases, if there is a conflict between Article 5 of the UCC and the provisions of “[rules of custom or practice, such as [the UCP]]” that is incorporated in the letter of credit, the rules of the UCP will prevail. Therefore, except where there is a conflict between mandatory provisions of the UCC and the UCP, the UCP will govern if incorporated in the letter of credit by reference.

Finally, as will be further discussed, an important aspect of letter of credit law is its interplay with Federal bankruptcy laws and state laws.

The Letter of Credit as Security Under the Lease. A letter of credit can be a powerful tool for a commercial landlord (and by extension its mortgage lender), especially in the current real estate market. Assuming that the landlord and tenant have agreed that a letter of credit will be used instead of (or in addition to) a cash security deposit and/or guaranty, the typical commercial or industrial lease will contain specific requirements for the letter of credit itself. For reasons discussed below, the required letter of credit should be an “unconditional, clean, irrevocable letter of credit” that is “callable at sight.” In addition, the qualifications for the issuer should be set forth in the lease; these qualifications typically require that the issuer be a solvent and nationally recognized bank whose deposits are insured by the Federal Deposit Insurance Corporation (“FDIC”). Minimum credit ratings from credit rating agencies such as Fitch, Standard and Poor’s, and/or Moody’s should be considered.

The letter of credit also should have an expiry date that is some period (such as 60 or 90 days) beyond the scheduled expiration of the lease to allow ample time for the landlord to determine the existence and extent of any damages to the premises, and because drawing on the letter of credit is a process that might not succeed on the first attempt. Due to their reserve requirements and for other reasons, most banks will typically

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8 UCC Section 5-103(c) specifically permits the parties to vary Article 5 “by agreement or by a provision stated or incorporated by reference in an undertaking.” See generally, Jeffrey S. Wood, Drafting Letters of Credit: Basic Issues Under Article 5 of the Uniform Commercial Code, UCP 600, and ISP98, BANKING L.J., Feb. 2008, at 103.

9 Avoidance of any preference issues under the Bankruptcy Code may also be a reason to allow additional time. See “Bankruptcy Considerations” below. Presentation of actual documents in person (as opposed to by electronic means) is
not issue a letter of credit with an expiration date that is more than one year after the date of issuance. If the lease has a lengthy term, it is generally acceptable for the letter of credit to have a shorter term, as long as it provides for automatic renewals. Such renewals should be for successive one- or two-year periods, unless the issuer gives the beneficiary advance notice (customarily 45 to 90 days) of its intention not to renew the letter of credit (sometimes referred to as an “evergreen” provision). The lease or other governing agreement should provide that the issuer may draw on the letter of credit if it has not been renewed or replaced by a date that is, say, 30 days prior to its expiration, or if the issuer’s creditworthiness diminishes. As will be seen, however, steps may need to be taken to prevent the tenant (or its bankruptcy trustee) from requiring disgorgement of the proceeds. Other requirements for the letter of credit itself are discussed below, and a sample form is attached as Appendix A.

Determining the amount of the letter of credit will depend upon the circumstances of the particular lease, and such determination will be similar to that relating to the amount of a cash security deposit. Some leases provide that the required or “face” amount of the letter of credit will automatically be reduced upon the occurrence of certain events, such as a demonstrated increase in the tenant’s net worth, a reduction of space under the lease, or the mere passage of time without a default (sometimes referred to as a “burn down” provision). In contrast, the letter of credit might be required to be increased if the tenant acquires additional space, or if it suffers a reduction in net worth. In any of these cases, clear requirements for an additional letter of credit (or a substitute letter of credit having the revised face amount) should be set forth in the lease. The face amount of the letter of credit generally cannot be changed of its own accord, so the lender will have to make sure that the tenant’s obligation to obtain a new letter of credit is clear, and that it has adequate protection if the tenant fails in that obligation.

Disregarding for the moment the rights of the lender, the lease should provide that if the landlord draws on the letter of credit, the proceeds may be used to compensate the landlord for its damages as the result of the tenant default, including without limitation damages permitted under applicable law (such as California Civil Code Sections 1951.2 et seq.). Commercial leases often limit the amount drawable to the amount of the landlord’s current damages, but landlords may want the ability to draw upon the entire letter of credit and deposit any unused amounts in the same manner as cash security deposits. In the event of a draw on the letter of credit, the tenant should agree to provide an additional letter of credit immediately (perhaps within 10 days after demand), in an amount necessary to make up the deficiency in the required letter of credit amount set forth in the lease. However, the presumably lower creditworthiness of the tenant may make this an unlikely remedy.

The lease should set forth in precise detail the events that will permit the landlord (and by extension, the lender) to draw upon the letter of credit. The exactness of the provisions on this issue are probably the most important for all parties. Triggering events should include any default by the tenant (after any negotiated periods of grace, notice, and/or cure), the filing of a petition under the Bankruptcy Code by or against the tenant, or if the tenant is placed into receivership or executes an assignment for the benefit of creditors. Common trigger events also include any notification from the issuer that it will not renew or extend the letter of credit beyond its expiry date (unless the tenant provides a replacement letter of credit at least 30 days prior to the expiry date), or if there is a material adverse change in the financial condition of the issuer (including any rating downgrade), unless the tenant provides a replacement letter of credit from an acceptable issuer within 10 days after landlord’s demand. The latter provision is particularly important where a long-term credit is involved, because in such cases there is more opportunity for an issuer to suffer a downgrade.

If there is nothing due to the landlord under the terms of the lease, but the landlord or the lender holds proceeds of a letter of credit solely because of failure of the tenant to renew a letter of credit, the tenant may be able to force disgorgement of such proceeds, arguing unjust enrichment.10 As explained by the court in In Re Builders Transport, Inc., “[T]he doctrine of independence protects only the distribution of the proceeds of the letter of credit. . . Once the proceeds of a letter of credit have been drawn down, the underlying contracts become pertinent in determining which parties have a right to those proceeds.”11 However, one commentator argues that if the lease contains a provision that automatically accelerates all rental payments upon such an event (discounted to present value), the landlord (or its lender) should be able to retain the full amount of the proceeds (up to the amount of accelerated rent) because the landlord is entitled to such proceeds under the terms of the lease.12

Whatever the lease provides regarding a trigger event, what should the letter of credit require for a draw thereunder? Many letters of credit require a “certification” from the beneficiary as to the existence of the tenant default or other trigger event. The tenant (the applicant under a letter of credit) will want the requirements for a draw on the letter of credit to be detailed, even complex. Some letters of credit require not only a certificate from the beneficiary as to the existence of a default under the underlying document, but even documentation supporting that claim. However, the lender wants the letter of credit to be the functional equivalent of cash, and does not want to be stymied by the “strict compliance” principle of UCC Section 5-108(a). It is true that under that Section, the issuer technically is required to honor the draw if the exact statement required by the letter of credit is submitted by the beneficiary. Tenants argue that at a minimum, the letter of credit should require a statement from the beneficiary that “a default has occurred” or that the lender “is en-

10 In In Re Builders Transport, Inc., 471 F.3d 1178 (11th Cir. 2006); First Avenue West Building, LLC v. James (In re Onecast Media, Inc.), 439 F. 3d 558 (9th Cir. 2006).
11 In In Re Builders Transport, Inc., supra note 10, at 1186.
12 See In re Stonebridge Technologies, Inc., 430 F. 3d 280 (5th Cir. 2005) (the lease contained an acceleration clause and the landlord was able to retain the full amount of the proceeds). See also Ken Miller, Using Letters of Credit, Credit Derivatives, and Other Forms of Credit Enhancements in Net Lease Transactions, 4 Va. L. & Bus. Rev. 45 (2009) (including a discussion of the enforceability of a rent acceleration clause).
titled to draw upon this letter of credit.” But the lender should object to this because even a seemingly minor departure from the required language might cause the issuer to reject the presentation because of the “strict compliance” requirement: The letter of credit should only require presentation of a draft for payment (in addition to the original letter of credit itself).

It also is advisable for the lease to clearly state that the letter of credit is not a “security deposit” under applicable law. Even with respect to commercial properties, state laws governing lease security deposits often limit the remedies of a landlord with respect thereto, such as setting forth a time frame by which a security deposit must be refunded, or limit claims from a security deposit to sums reasonably necessary to remedy defaults in payment of rent, repair of damage caused by the tenant, and so forth. (See, e.g., California Civil Code Section 1950.7) As will be seen, there are also disadvantages in a bankruptcy situation that should be avoided.

The letter of credit issued on behalf of a tenant not only shifts the burden of a possible insololvency of a tenant to the issuing bank, it also avoids the risk of non-payment during a dispute between the landlord and the tenant. As such, the landlord’s mortgage lender, if it obtains an interest in the letter of credit, is able to disassociate from downstream issues that may arise between the landlord and tenant.

The Lender’s Interest in the Letter of Credit. Except for small letters of credit, lenders often insist that they have a perfected security interest in any letter of credit provided by a tenant. But they may not realize the various levels of protection that are available, advisable, or even necessary to realize the practical benefit of the letter of credit issued for the benefit of the landlord-borrower. Article 5 and Article 9 of the UCC are each relevant to this discussion (and all Section references hereafter will be to the UCC unless otherwise indicated). First, a definition: a “letter of credit right” is defined in Section 9-107, "control" means that the issuer has consented to the assignment of the proceeds of the letter of credit (issued in the borrower’s name). The landlord assigns its interest in the letter of credit proceeds to the lender, and obtains the issuer’s consent to such assignment. The problem remains that unless the landlord-borrower makes a timely and appropriate draw under the letter of credit, there will be no proceeds against which the lender may seek recourse. Perhaps the borrower would provide a power of attorney in favor of the lender to draw on the letter of credit in the event of a lease default. Unfortunately there is no certainty that the issuer of the letter of credit would honor the power of attorney, particularly if the tenant or the borrower disputes the power of attorney at the time the letter of credit is presented.

To summarize the challenge, if the landlord-borrower is the beneficiary of the letter of credit, the lender will not be able to draw on it if there is a tenant default. It will have to trust the landlord to do so, and (if the proceeds have not been assigned to the lender) also trust the landlord to deposit the proceeds in a lender-controlled account. (If the proceeds have been assigned, the consent document from the issuer will usually obligate the issuer to wire the funds to an account designated by the lender.) In the event of a concurrent tenant default and loan default, what assurance exists that the borrower will draw on the letter of credit, even if so obligated under the loan documents? In some instances, the lender might even need to pursue an injunction to prevent the landlord from drawing on the letter of credit and disposing of the proceeds.

Therefore, the only way to provide real assurance to the lender is to have the letter of credit issued to the lender as beneficiary, for the lender to ensure that it has possession of the letter of credit, and for the lender and the landlord-borrower to have a separate agreement that sets forth the conditions under which the lender can draw upon the letter of credit. The lender would thus be expressly named as the beneficiary of the letter of credit and would obtain the right to draw directly under the letter of credit (always subject to the terms of

13 A security interest perfected by control is superior to an interest perfected under the automatic perfection provisions which apply to supporting obligations. U.C.C. § 9-329(1).
the lease) and receive the proceeds thereof. As discussed below, there also may be some advantages to being the beneficiary of the letter of credit in the event of the tenant’s bankruptcy. The lease will provide the agreement between the landlord and the tenant; the agreement between the landlord and the lender will need to set forth a mechanism for the lender to learn that a lease default exists, and also will need to set forth the lender’s rights (a) if a loan default also exists or (b) if a loan default does not exist. (See “The Landlord-Lender Agreement” below.)

The landlord-borrower may be concerned because it is the landlord, not the lender, that has the contractual relationship with the tenant regarding the letter of credit. The landlord or the tenant may be worried that the lender might inadvertently draw upon the letter of credit; this could damage the tenant’s credit rating or require the tenant to post additional collateral with the issuing bank. (Once the issuer has honored a draw, the independence principle no longer controls and the applicant may sue the beneficiary for violation of any underlying agreement, such as the lease.) The landlord might be concerned that the lender may not allow a draw even if the landlord believes there has been a tenant default, or might even allow a letter of credit to expire if the tenant did not renew it.

Unfortunately, while there are alternatives to having the letter of credit issued in the lender’s name, they do not appear to be satisfactory. For example, the lender could take possession of a letter of credit that is issued in the borrower’s name, and the borrower could grant a security interest in the proceeds to the lender. Provided the consent of the issuer is obtained, the lender would thereby obtain an “assignment of proceeds” of the letter of credit under Article 5 of the UCC. But a number of unique and problematic provisions would need to be included in the security agreement. Assume that a letter of credit is not renewed when required but no lease default exists, and the borrower exercises its right to draw on the letter of credit and holds the proceeds as cash. In such a case, the security agreement would have to require the borrower to take all steps to insure that the lender has a perfected security interest in the account in which the cash is held. Some have suggested establishing an escrow arrangement for the letter of credit, but in the event of a dispute the escrow holder would presumably be unable to act without a court order; in the process, the letter of credit might expire.

The lender could also consider adding a carveout from the non-recourse provisions of the loan for a failure to draw on the letter of credit in the event of a default under the lease, or a failure to deliver the proceeds to the lender. While this could provide the landlord-borrower with an incentive to draw under the letter of credit in the event of a lease default, the only advantage to the lender would seem to be avoidance of allegations that could lead to lender liability claims. These allegations could include an improper draw on a letter of credit because it had not been renewed when required before the expiration date, or for alleged tenant defaults. If the letter of credit is not issued in the lender’s name, the lender would avoid these issues, but it also would have significantly less control over the letter of credit.

Therefore, to effectively be in a position to draw on the letter of credit, the lender should be the beneficiary and have possession of the letter of credit. Note again that under Section 9-102(a)(51) of the UCC, a “letter of credit right” does not include a right of the beneficiary to demand payment. The lender will need to be willing to undertake the obligation to draw upon the letter of credit in accordance with all the provisions of the lease and the separate agreement between borrower and lender—and the obligation to return the letter of credit in the absence of any defaults.16

The essential document for the lender, in addition to the lease and the letter of credit itself, is a separate letter-of-credit agreement with the landlord-borrower regarding the lender’s rights with respect to the letter of credit. Assume that the lender is the beneficiary, the parties should agree on the conditions under which the lender may draw on the letter of credit, and on the lender’s use of the proceeds (depending on whether a loan default exists or does not exist). A form of such agreement is attached as Appendix B.

Assume that there is no loan default, but the landlord would be entitled to draw upon the letter of credit. This could occur either because the letter of credit is about to expire and has not been renewed, the issuer has suffered a downgrade in its credit rating, or there has been a tenant default. In drafting the letter of credit agreement, the parties should consider the following issues:

(a) Lender’s notice rights in the event of a tenant default. The borrower must be obligated to immediately notify the lender of any tenant default, using a form of certification previously agreed on (see Appendix B, Section 2 and Schedule 2) and to provide all relevant information and documents in connection with any such default. The lender should be able to draw on the letter of credit if it becomes aware of a tenant default even if it has not received a notice from the borrower.

(b) Lender’s decision to make a full or partial draw. Some leases provide that any draw under the letter of credit should not exceed an amount reasonably necessary to cure the existing tenant default. If it does not, should the lender draw the entire amount of the letter of credit? Generally, the lender will want to avoid making multiple draws on the letter of credit if the tenant is repeatedly in default. On the other hand, if excess proceeds from a draw are placed in an account and treated like a security deposit, there may be additional potential

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14 CRM Collateral II, supra note 4, at *26; White & Summers, supra note 3, at § 26-7.

15 As one commentator has observed, the tenant may not agree to this structure if it is doing an off balance sheet sale-leaseback, as such arrangement probably constitutes “continuing involvement” under FAS 88 thereby precluding off balance sheet treatment. Miller, supra note 12, at 51 (referring to Accounting for Leases, Statement of Financial Accounting Standards No. 98 (Fin. Accounting Standards Bd. 1988)).

16 The above solution may not be practical if the lender is making a loan to a borrower secured by a property with a number of existing tenants, each with letters of credit securing their lease obligations. In such a case, the lender may require the borrower to covenant to use its best efforts to cause each tenant to have its letter of credit replaced and reissued so that all such existing letters of credit name the lender as beneficiary, and otherwise satisfy lender’s requirements. Until the existing letters of credit are replaced, the lender may want to retain possession of them; this may prevent the borrower from drawing upon them without the lender’s consent, but would not allow a draw by the lender.
risks in the event of a tenant bankruptcy. The tenant’s bankruptcy trustee could argue that the cash should be deemed to be part of the bankruptcy estate. Under such circumstances, the most favorable course would be for the landlord and the lender to consult with one another to evaluate the advantages and disadvantages of negotiating a cash cure of the tenant default versus drawing on the letter of credit. The agreement would (

(c) Lender’s control of proceeds of a draw. Assuming that the lender is the beneficiary of the letter of credit, the lender should be permitted to draw on the letter of credit and place the proceeds in a collateral account that is pledged to the lender. If the borrower is the beneficiary, the borrower should be obligated to deposit any draw on the letter of credit into an account designated by the lender, and to take all steps necessary to ensure that the lender has a perfected security interest in such account.

(d) Grant of security interest. The landlord should grant to the lender a broad security interest in the letter of credit and all proceeds thereof (even if it is the beneficiary), together with all accounts into which such proceeds may be deposited, all insurance on such accounts, and all similar or related rights. (As discussed, if the lender is not the beneficiary, it will need to obtain the consent of the issuer to the assignment of proceeds.)

(e) Lender’s right to comingle proceeds of a draw. The lender will want the right to comingle the proceeds with other funds of the lender (assuming no laws prohibit such commingling), and to transfer the proceeds to any purchaser of the loan.

(f) Lender’s right to hold or reallocate proceeds after a draw. If there is no loan default, the borrower will generally request that the lender release the proceeds to the borrower immediately. The lender will insist that the proceeds be used to cure the lease default, and perhaps that any additional proceeds be used to make payments on the loan and to pay property taxes, insurance premiums, and so forth. The parties may also negotiate a provision allowing the proceeds of a draw to be used for costs in connection with re-leaseing any space vacated by the defaulting tenant. The lender may require an indemnification from the borrower before releasing the proceeds.

Now assume that a lease default has occurred, and that there is also a loan default. The lender should be able to follow the steps above, and apply the letter of credit proceeds to the debt or any other obligations of the borrower under the loan documents. The landlord-lender agreement should make it clear that the lender can also exercise any other available remedies, before or after drawing on the letter of credit. See Appendix B, Section 5 for an example provision.

Would the lender be protected if the letter of credit is issued to both the landlord and lender as co-beneficiaries? This might be an acceptable arrangement if the letter of credit provides that the lender may draw on the letter of credit without the signature of the borrower. The lender, the landlord and the tenant could enter into a three-party agreement. The agreement would essentially provide that (i) as between lender and tenant and between landlord and tenant, the lease will govern any drawings under the letter of credit and the use and application of proceeds of any drawings, (ii) lender will only be entitled to draw on the letter of credit if and to the extent that borrower is entitled to do so under the lease, and (iii) as between lender and borrower, the mortgage and other loan documents will govern as to which of borrower or lender shall have the right to draw on the letter of credit, whether the proceeds shall be paid to borrower or retained by lender, and the order of application of proceeds against borrower’s obligations under the loan documents. Of course, whether this solution will allow the benefits of the letter of credit to flow through to the lender will largely depend upon which party retains possession of the letter of credit—the borrower or the lender.

Because the lease may allow, or require, that the letter of credit be modified or substituted from time to time, the agreement should provide that the lender will deliver the original letter of credit, pursuant to some escrow arrangement, in exchange for the substituted letter of credit. This may require personal delivery of the existing letter of credit to the issuer, especially because banks are reluctant to issue a new letter of credit except upon concurrent return (often in person) of the existing one. Any new or modified letter of credit should be delivered directly to the lender, not to the landlord. The lender should not be required to accept any new or substituted letter of credit (especially in a reduced amount) unless the lease expressly permits such substitution.

State Law Considerations. Consideration should be given to any unique laws or requirements of various jurisdictions that concern letters of credit as well as the corresponding rights held by each of the parties involved. For example, in some jurisdictions, a lender is subject to significant limits on the manner in which it may foreclose upon real property or other security, including preclusion of obtaining a deficiency judgment after a non-judicial foreclosure, a “security-first” requirement, and perhaps a “one form of action” rule. Certain states have enacted legislation to address the foregoing concerns. However, in states and jurisdictions that lack such lender-friendly legislation, the presentment, receipt of payment, or demand for payment under a letter of credit could be limited or result in unintended adverse consequences.

Bankruptcy Considerations. In the event that the tenant seeks protection under the Bankruptcy Code, application of, among other sections, Section 362’s automatic stay, the Section 502(b)(6) cap on a landlord’s damages, and the rules regarding voidable preferences under Section 547 present complex issues to the beneficiary. This results in part because of the unique inter-relationship among the applicant, the issuer, and the beneficiary.

As stated above, the automatic stay provisions under Section 362 of the Bankruptcy Code (which prohibit en-

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17 For example, in California there was formerly great concern that despite the independence principle, drawing on a letter of credit could constitute an “action” which would violate the “one action” rule under Section 726 of the California Code of Civil Procedure, and thereby cause the lender to forfeit all of its real property security. To the relief of lenders, Section 580.5 was enacted which specifically excluded from the one action rule and the antideficiency laws, enforcement of a demand for payment under a letter of credit, as well as the payment of, or enforcement of any reimbursement obligation relating to, a letter of credit by the issuer of the letter of credit, whether done before or after foreclosure of any real property security.
forcement actions against the debtor) do not apply to a draw upon a letter of credit.\textsuperscript{18} Based upon the independence principle, the letter of credit is an independent obligation of the issuer, and not property of the bankruptcy estate. Bankruptcy courts have recognized the independence principle and have held that the proceeds of a letter of credit are not property of the debtor’s bankruptcy estate. Bankruptcy courts cannot enjoin a draw under a letter of credit.\textsuperscript{19}

However, consider the situation where the letter of credit requires a certification from the beneficiary that the landlord has given notice to the tenant of the tenant’s right to cure the default and that the requisite number of days set forth in the lease have elapsed without cure. This and similar actions, if required, could be prohibited by the automatic stay. The issue does not arise as a result of the act of drawing on the letter of credit (because it is not treated as property of the debtor for purposes of Section 362). The problem merely arises from a certification requirement that cannot be satisfied because of the automatic stay imposed by Section 362. It may be possible (with some expense and delay) to obtain relief from the stay, but it would seem preferable to avoid the risk altogether and not include such a notice and cure right.

Is a letter of credit draw affected by the damage award cap imposed by Section 502(b)(6) of the Bankruptcy Code? That Section provides that a landlord’s claim for early termination of a lease is limited to the rent due under the lease for the greater of one year or 15 percent of the rent reserved in the lease for the remaining term, not to exceed three years of rent. The landlord may have to refund a cash security deposit to the extent it exceeds this cap. Therefore, most landlords do not request, and most tenants do not provide, security in an amount that exceeds the cap under Section 502(b)(6). An advantage of a letter of credit is that it is generally believed that it is not subject to the cap imposed by Section 502(b)(6).\textsuperscript{20}

However, this may not be true if the issuer holds collateral as security. In the case of In re Mayan Networks Corporation, 306 B.R. 295 (B.A.P. 9th Cir. 2004), the tenant secured the letter of credit with a cash security deposit provided to the issuer. The landlord drew on the letter of credit after the filing of the tenant’s bankruptcy petition. The draw was less than the Section 502(b)(6) cap, but the court held that the draw had the same effect on the bankruptcy estate as the forfeiture of a cash security deposit. The court determined that Section 502(b)(6) applied and therefore the landlord’s claim in bankruptcy should be reduced by the amount that the

landlord had received from drawing on the letter of credit. The court focused on the effect on the debtor’s estate, and reasoned that, ultimately, the debtor should not be liable for more than the statutory cap. “Once the allowable claim (up to the Section 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.”\textsuperscript{21} Further, the lease provided that the letter of credit was security for the lease, and the letter of credit was fully secured by a cash deposit from the tenant. Accordingly, the court considered the letter of credit as a security deposit, and therefore “the draw upon the letter of credit will be applied in satisfaction of the landlord’s claim against the debtor and the amount of such a claim will be reduced by the amount of the draw.”\textsuperscript{22}

Similarly, in In re Connectrix Corporation, 372 B.R. 488 (Bankr. N.D. Cal. 2007), the court held that the landlord’s allowable claim was to be reduced by the landlord’s post-surrender, pre-petition draw on the letter of credit. The court determined that when a letter of credit is issued in lieu of a security deposit, it should be treated the same as a security deposit under Section 502(b)(6).\textsuperscript{23} The court concluded that, under Section 502(b)(6), “the amount of the landlord's allowable claim must be calculated as of the date the lease was surrendered... [and therefore] any proceeds received following surrender should be applied against the capped claim.”\textsuperscript{24} Accordingly, if a letter of credit is treated as a security deposit, a draw on the letter of credit, whether pre-petition or post-petition, may reduce the allowable claim under Section 502(b)(6), at least where the issuer is secured by assets of the tenant.\textsuperscript{25}

However, in In re Stonebridge Technologies, Inc., 430 F.3d 260 (5th Cir. 2005), the court held that Section 502(b)(6) did not limit the beneficiary’s right to the full proceeds of the letter of credit. The court focused on the fact that the lease contained an acceleration of rents clause that allowed the landlord to demand all rents due under the lease immediately. In addition, the court noted that Section 502(b)(6) applies only to those claims made against the estate and the landlord did not file a proof of claim in the case.\textsuperscript{26} Therefore, the court

\textsuperscript{19} Note, however, the automatic stay imposed under Section 362 presumably would apply to the issuer’s enforcement of its reimbursement right against the applicant. Section 362 stays “any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.” 11 U.S.C. § 362(a)(6). See Arrow Air, Inc. v. United Airlines (In re Arrow Air, Inc.), 70 B.R. 245 (Bankr. S.D. Fla. 1987).

\textsuperscript{20} See In re Compton Corp. supra note 7; see also In re Papi Leno Club, Inc., supra note 7.

\textsuperscript{21} In re Mayan Networks Corp., 306 B.R. at 310.

\textsuperscript{22} Id. at 301; see also, First Ave. W. Bldg. LLC v. James (In re OneCast Media, Inc.), 439 F.3d 558 (9th Cir. 2006). See generally Miller, supra note 12; Alan N. Resnick, Letter of Credit as a Landlord’s Protection Against a Tenant’s Bankruptcy: Assurance of Payment or False Sense of Security?, 82 Am. Bankr. L. J. 497 (2008).

\textsuperscript{23} In re Connectrix Corp., 372 B.R. at 494-96; see also In re AB Liquidating Corporation (AMB Property L.P. v. Official Creditors), 416 F.3d 961 (9th Cir. 2005); In re PPI Enterprises (U.S.), Inc. (Solow v. PPI Enterprises (U.S.), Inc.), 324 F.3d 197 (3d Cir. 2003).

\textsuperscript{24} In re Connectrix Corp., 372 B.R. at 495; see also In re PPI Enterprises (U.S.), Inc., 324 F.3d 197.

\textsuperscript{25} But see Resnick, supra note 22 (discussing In re PPI Enterprises (U.S.), Inc., In re AB Liquidating Corp. and In re Mayan Networks Corp., and consider whether each may or may not be limited to their particular facts); see also Miller, supra note 12.

\textsuperscript{26} Note that simply failing to file a proof of claim will not necessarily allow the beneficiary of a letter of credit to circumvent the Section 502(b)(6) cap; Section 501(c) provides that “if a creditor does not timely file a proof of such creditor’s claim, the debtor or trustee may file a proof of such claim.” Ad-
determined that Section 502(b)(6) was not triggered.27 Yet, the court suggested that, even if a claim had been filed, Section 502(b)(6) would not prevent the landlord from drawing on the letter of credit in an amount exceeding the cap. The court went on to indicate that limiting the landlord’s ability to draw beyond the Section 502(b)(6) cap “converts § 502(b)(6) into a self-effectuating avoiding power that would allow the trustee to bring an adversary proceeding against a lessor who exercises his rights under a letter of credit.”28

As discussed above, if there is a tenant default and the lease does not limit the amount drawable to the amount of the landlord’s current damages, the landlord—or the lender—may want to draw upon the entire letter of credit and deposit any unused amounts in the same manner as cash security deposits. Similarly, if the lender receives a notice from the issuer that it will not be renewing a letter of credit that the tenant is required to maintain, it may want to draw upon the letter of credit to prevent its security from disappearing. If the landlord turns the proceeds into a cash security deposit, in a later bankruptcy of the tenant, the tenant might argue that the cash is part of the bankruptcy estate. The tenant would seem less likely to prevail if the draw on the letter of credit was based upon the tenant’s monetary default (rather than the failure to renew the letter of credit), and also if the letter of credit is not collateralized. If a rent acceleration clause is likely to be enforceable in the applicable jurisdiction, based on the Stonebridge case it probably should be included so that the letter of credit proceeds can be applied to the unpaid rent. In any event the tenant presumably would have to provide adequate protection under the Bankruptcy Code. Again, the lease should make it clear that the letter of credit is not intended as a security deposit. While there may not be a clear solution to this problem, prudence dictates that the lender (and the landlord) carefully evaluate the risk of a later tenant bankruptcy with the risk of not having the entire proceeds of the letter of credit immediately available and to decide which is more beneficial under the particular circumstances.

Are there any preference issues involved with payment of a letter of credit? If the tenant provides a letter of credit substantially concurrently with the execution of the lease, there is no preference because there is no antecedent debt involved.29 If the lender or landlord draws on the letter of credit and within 90 days the tenant files a Chapter 11 case, there is no preference because there is no transfer of the tenant’s property.30 There may also be an avoidable preference if, after a lease default, the tenant provides a letter of credit that is secured by property of the tenant. Even though the letter of credit and any payments thereunder do not involve property of the tenant, some courts have held that there may be an indirect preference.31 The problem might be avoided (as it were) by insuring that the letter of credit does not expire until well after the lease expiration date (at least 60 to 90 days after the lease expires) to allow for the preference period to expire and for the lender to receive notice of any bankruptcy filing.32

**Presentation: Issuer Defenses.** When presented with a demand for payment, the issuer has few, if any, defenses. The entire purpose of the letter of credit (quick and assured payment) would be undermined if the issuer were required to determine the outcome or fairness of any dispute between the applicant and the beneficiary. Indeed, that is the fundamental basis for the “independence principle.” The only function of the issuer is ministerial; it must only determine whether the draft and/or other documents provided to the issuer conform to the documents required by the letter of credit. Fraud in the presentation of documents is virtually the only defense available.33 This again points out that letters of credit are not based upon “fairness” or the implied covenant of good faith and fair dealing and therefore can provide the unique credit support that landlords—and their lenders—desire.

What constitutes “strict compliance”? Strict compliance has been held to allow for inconsequential errors, such as typographical errors where the issuer cannot have been misled.34 More difficult questions may arise, such as where conflicting documents are presented by the beneficiary, or where the beneficiary has changed its name or merged with another company.35 Most of these difficulties can be avoided by careful drafting of the letter of credit, as will be discussed below.

Under Section 5-108(b) of the UCC, an issuer has a reasonable time after presentation, but not beyond seven business days after its receipt of documents, either to honor the letter of credit, or to give notice of discrepancies in the presentation.36 Under Section 5-108(c), an issuer who has refused to honor a draw may not assert additional reasons for dishonor after such seven business day period, except in cases of

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27 In re Stonebridge Technologies, Inc., 430 F.3d at 269-70.
28 Id. at 270.
30 However, a reimbursement payment by the tenant to the issuer could be an avoidable preference. See P.A. Bergner & Co. v. Bank One, Milwaukee NA (In re P.A. Bergner & Co.), 140 F.3d 1111. See generally, David Carlson and William Widen, Letters of Credit, Voidable Preferences, and the “Independence” Principle, 54 B. & C. L. W. 1661, 16887 (1999).
31 See, e.g., In re Compton Corp., supra note 7; see also In re Murphy’s Pub, Inc., 845 F.2d 293, 296 (11th Cir. 1988).
32 Id. at 269-70.
33 See Michael Baxter, Letters of Credit and the Powerline Preference Trap, 53 B. & C. L. W. 65 (1997). A bank trustee may be more likely to assert a preference claim against any proceeds that did not result from an actual tenant default if cash collateral was held for a long period of time.
34 See U.C.C. § 5-109.
36 See generally White & Summers, supra note 3, at § 26-5.
37 If the letter of credit is governed by the UCP, this period is only five (5) banking days. UCP Article 14.
fraud, forgery, or expiration of the letter of credit before the date of its presentation.\textsuperscript{37}

If a presentation is defective in some (perhaps minor) respect, can the applicant waive the requirement and allow the issuer to pay the beneficiary? One treatise points out that this is nothing more than a modification of the agreement to which the applicant, the issuer, and the beneficiary have agreed, that such waivers are not infrequent and the issuer will typically pay.\textsuperscript{38} If subsequent partial presentations are also defective, the first waiver is not an automatic waiver of the defect in later presentations,\textsuperscript{39} so lender-beneficiaries should be cautious when making repeated presentations.

If the issuer is a bank or other institution insured by the Federal Deposit Insurance Corporation, there may be some risk that if the issuer fails, the FDIC will take over the institution. If so, the FDIC has the power to disaffirm or repudiate any contract to which the issuer is a party provided that it determines that the performance of such contract would be "burdensome" and the disaffirmance would "promote the orderly administration of the institution's affairs."\textsuperscript{40} This emphasizes the fact that the lender should investigate the strength of the issuer prior to agreeing to accept a letter of credit, monitor the issuer's continuing solvency during the term of the letter of credit, and require that the tenant provide a replacement letter of credit upon any downgrade of the issuer's rating.

\textbf{Suretyship and Subrogation Issues.} In some cases, the applicant under the letter of credit is not the tenant itself, but a parent or other affiliate that is providing credit enhancement under the lease. The interest of such party would be very similar to the tenant. Even if not designated as such in the letter of credit, both parties would presumably be considered to be "applicants" under UCC Section 5-102(a)(2). If an obligation to reimburse the issuer arises, some have argued that the applicant is entitled to the defenses available to a surety, such as discharge (including alteration of the underlying obligation by the other parties to the disadvantage of the surety). The Ninth Circuit Appellate Court discussed these issues extensively in \textit{CRM Collateral} and stated that "the law on letters of credit is clear that simply entering into a letter of credit transaction does not a suretyship make."\textsuperscript{41} The hallmark of a surety relationship is a secondary obligation, which is absent in most letter of credit transactions. The court went on to say that "[i]nstead, the applicant and beneficiary owe each other primary obligations on the underlying contract, the issuer is primarily obligated to honor the beneficiary's proper draw request, and the applicant is primarily obligated to reimburse the issuer for any payments made to the beneficiary."\textsuperscript{42} Moreover, this is not inconsistent with the subrogation rights of the issuer or applicant—that is, the right to step into the shoes of the beneficiary and assert a right to performance or payment.\textsuperscript{43}

UCC Section 5-117 specifically provides for subrogation rights in certain cases, but only after the issuer has paid on a letter of credit. Once the primary objective of the independence principle has been achieved (immediate payment to the beneficiary), there is no reason to prevent the subrogation rights enumerated in the statute. Thus, (a) an issuer that honors a beneficiary's presentation is thereafter subrogated to the rights of the beneficiary "to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as if the issuer were the secondary obligor of the underlying obligation owed to the applicant," and similarly, (b) an applicant that reimburses an issuer is subrogated to the rights of the issuer against any beneficiary "to the same extent as if the applicant were the secondary obligor of the obligations owed to the issuer," and also has "the rights of subrogation of the issuer to the rights of the beneficiary stated in [clause] (a)." Section 5-117 balances the claimant's right to subrogation and the independence principle by precluding any defenses or rights until after payment is made under the letter of credit.\textsuperscript{44}

\textit{Form of Letter of Credit.}

While letters of credit are governed by the UCC, the UCP, and other rules, the most important rule to follow is to carefully negotiate the language of the letter itself. Whether a letter of credit is to be provided at the inception of a pending transaction, or is required to be delivered at some date or happening in the future, the form of the letter of credit should be agreed upon as early as possible and with as much exactness as possible. Issuing banks typically have their own standard forms of letters of credit. If the issuer is not to be identified until a later date, it may be somewhat difficult to agree upon a precise form. The landlord's lender will also have its own requirements, but too often even though the lender's identity is known when the lease is negotiated, it will not be consulted until late in the process. If the proposed issuer is known, it should prepare a draft form of the letter of credit as soon as possible for comment by the borrower and the lender. A suggested form of a letter of credit that would be acceptable to most lenders is attached as Appendix A. The following are some of the more important considerations:

(a) \textit{The Issuer.} The lender may need time to evaluate the issuer and its acceptability as a provider of the letter of credit. If the issuer is not a well-known institution, the lender will need to carefully evaluate the strength and solvency of the issuer. It is helpful if the issuer has an office in a major city where the lender is located so that the letter of credit can be easily presented if necessary. "Issuer" is defined in Section 5-102(a)(9) of the UCC and is often a bank, but need not be.\textsuperscript{44}

(b) \textit{Irrevocability.} Although Section 5-106(a) of the UCC states that a letter of credit is revocable only if it so provides, it is still customary and prudent practice for the letter of credit to state on its face that it is "irrevocable."

(c) \textit{Designation of Beneficiary.} As stated above, it is preferable for the lender to be the beneficiary under the letter of credit. If there are several lenders, they should

\textsuperscript{37} Note also that under Section 5-108(i) of the UCC, if the draft is forged by a third party, and the issuer pays on the basis of facial conformity of the draft documents, the issuer is not relieved of its obligation to pay the true beneficiary if such beneficiary presents conforming draw documents.

\textsuperscript{38} White & Summers, \textit{supra} note 3, at § 26-5(b).

\textsuperscript{39} See U.C.C. § 5-108, comment 7.

\textsuperscript{40} 12 U.S.C. § 1821(e)(1).

\textsuperscript{41} CRM Collateral II, \textit{supra} note 4, at *18.

\textsuperscript{42} Id. (distinguishing \textit{Ochoco Lumber Co. v. Fibrex & Shipping Co.}, 994 P.2d 793 (Or. Ct. App. 2000)).

\textsuperscript{43} Id.

\textsuperscript{44} White & Summers, \textit{supra} note 3, at § 26-14.
take steps to agree upon a process to protect the rights and interests of each, such as naming one lender as the agent for the others. Note also that in paragraph G of Appendix A, the term “Beneficiary” expressly includes any successor by operation of law.

(d) Sight Draft. As stated earlier, the lender wants the functional equivalent of cash. The only requirement for drawing on the letter of credit should be the presentation of a sight draft. If the lender draws on the letter of credit, it will do so knowing that it has the right to do so, and also knowing that it will be liable for a wrongful draft. For a form of sight draft, see Schedule 1 to Appendix A.

(e) Expiry Date.

Ideally, the tenant will not default and the lender will never need to draw upon the letter of credit. In that case, the lender may return the letter of credit, destroy it and provide a written statement that it was destroyed, authorize and consent to its cancellation, or simply allow the letter of credit to expire under its own terms.

The length of the term of the letter of credit will depend on the nature of the obligation being secured. For example, an obligation to pay rent would continue until the end of the lease term; an obligation to contribute towards tenant improvement work would only continue as long as the work is not completed. Furthermore, the length of the term of the letter of credit may be shorter than the length of the term of the lease. In such circumstances the parties should obtain an evergreen letter of credit, as discussed earlier.

The expiration date should be clearly stated as a date certain (not as a designated number of days after issuance). The UCC provides that if there is no stated expiration date or provision for an automatic renewal, a letter of credit expires one (1) year after its issuance.45

The beneficiary should account for a buffer period of 60 to 90 days after the expiration of the underlying lease obligations (or specific lease obligation) for the beneficiary to have sufficient time to discover any latent issues that may require the beneficiary to draw on the letter of credit. For example, if the landlord or the lender have a claim for damages, it would be mutually advantageous to allow time to try to negotiate with the tenant before drawing on the letter of credit. Also, because of the “strict compliance” rule, the lender needs sufficient time to prepare the documents required for the draw—and time to solve any issues if the issuer dishonors an attempted draw. As stated above, under Section 5-108(a) of the UCC, an issuer shall honor a presentation that appears on its face “strictly to comply” with the terms and conditions of the letter of credit.

(f) Partial Drawings. Partial drawings and multiple presentations and drawings must be permitted. As noted above, because the lease may prohibit draws in excess of the landlord’s actual damages, and in part because of the danger that the proceeds might become subject to the tenant’s bankruptcy estate, the lender will want the flexibility of drawing only a portion of the letter of credit, with the ability to draw more at a later time.

(g) Transferring the Letter of Credit. The definition of “beneficiary” under the UCC broadly includes a person to whom drawing rights have been transferred under a transferable letter of credit.46 UCC Section 5-112 provides that a standby letter of credit is not transferable “unless it so states.” Therefore, the lender should require specific language in the letter of credit that provides the right to freely transfer the letter of credit upon written notice to the issuer in favor of lender’s successor entity, in the event that the loan is sold or otherwise transferred. The tenant may resist having it transferred to an unknown entity, or may desire that any transferee satisfy certain financial or other eligibility requirements. Lenders, however, will insist on not being fettered by such restrictions, but probably would agree that the successor must be liable for any liability caused by the original lender. If the lender is itself subject to possible financial difficulty, the ability of the lender’s future bankruptcy trustee to succeed to the lender’s interest as beneficiary may also depend upon the existence of express rights of transfer. (The reader should not confuse these issues with the beneficiary’s right to assign letter of credit proceeds under UCC Section 5-114 previously discussed.)

The issuer will have certain requirements for a transfer of the beneficiary’s interest, because it will be concerned about multiple transfers and the possibility of paying the wrong entity. (Note paragraph B in the sample form of Letter of Credit attached as Appendix A.) Similarly, any assignee of a letter of credit should ensure that the issuer has acknowledged and consented to the assignment and/or issued a replacement letter of credit in the assignee’s name. It is advisable to have the transfer form agreed upon and attached as an exhibit to the letter of credit. Moreover, lenders should avoid the issuer’s custom of requiring a guaranty of the signature of the transferring beneficiary. Major institutional lenders typically have various officers or other personnel who are authorized to execute such documents, but who do not have their signatures on file with a bank because of the cumbersome aspect of keeping such signatures up to date. At most, the issuer should require an incumbency certificate or other evidence that the signing officer is authorized to execute the transfer form. Requiring notarization is another alternative. To prevent the issuer from exacting a large fee for the transfer, it should be expressly stated that the transfer shall be without charge to the beneficiary or the transferee. The lender will argue that the lease should provide that the tenant is responsible for any such fees, and that the lender should be no worse off than if a cash security deposit were used in lieu of a letter of credit.

(h) Governing Law. The UCC, including Article 5, with certain variations is the law in most states that governs letters of credit. On the other hand, the UCP is not law but rather a private agreed-upon set of rules that is applicable “when the text of the credit expressly indicates that it is subject to these rules.”47 Therefore, the letter of credit should always specify the state whose laws will govern, and if the UCP also is to be incorporated therein, the governing law provision should so state. Since Section 5-116(c) of the UCC specifically governs situations where conflicts may arise, it is unnecessary and probably confusing to attempt to set forth which provisions should govern in the event of a conflict between the two sets of rules.

45 U.C.C. § 5-106(c).
46 See U.C.C. § 5-102(a)(3).
47 UCP 600 Art. 1. See generally Wood, supra note 8.
Conclusion. A Letter of credit can be a valuable method for providing additional credit in a lease transaction, and is often more beneficial than a cash security deposit or a guarantee. The landlord’s lender frequently insists that it be able to take advantage of a letter of credit provided by a tenant. Because of the uniqueness of letters of credit and the complex interplay of the rights of the various parties, the lender and its counsel should have a complete understanding of the laws, customs, and principles applicable to letters of credit, as well as the practical implications arising from a lease default, a loan default, or both.

Appendix A can be found at http://op.bna.com/rel.nsf/id/etor-8svpkx/$File/York-Appendix%20A.pdf.
Appendix B can be found at http://op.bna.com/rel.nsf/id/etor-8svpg7/$File/York-Appendix%20B.pdf.
APPENDIX A

FORM OF STANDBY LETTER OF CREDIT

APPROVED BY: ________________________________

DATE: ________________________________

______________________________

DATE OF ISSUE:

(Applicant’s name)

IRREVOCABLE STANDBY LETTER OF CREDIT NO.: __________________________

"BENEFICIARY": ________________________________ (name and address)

"ACCOUNT PARTY": ________________________________ (name and address)

"EXPIRY DATE": ________________________________, 20___, AND ANY AUTOMATICALLY EXTENDED DATE, AS HERElN PROVIDED.

"TOTAL AMOUNT": ________________________________

WE HEREBY ESTABLISH OUR IRREVOCABLE STANDBY LETTER OF CREDIT IN YOUR FAVOR, FOR THE ACCOUNT PARTY, FOR A SUM NOT EXCEEDING THE TOTAL AMOUNT, STATED ABOVE, AVAILABLE WITH ___________ (“ISSUER”), BY PRESENTATION OF THE FOLLOWING:

1. THIS ORIGINAL LETTER OF CREDIT AND ALL AMENDMENTS HERETO, IF ANY.

2. SIGHT DRAFT, DRAWN ON THE ISSUER AND REFERENCING THE LETTER OF CREDIT NUMBER INDICATED ABOVE, IN THE FORM ATTACHED HERETO AS “SCHEDULE 1,” DULLY EXECUTED.

A. IT IS A CONDITION OF THIS LETTER OF CREDIT THAT IT SHALL BE DEEMED AUTOMATICALLY EXTENDED WITHOUT AMENDMENT FOR A PERIOD OF ONE (1) YEAR FROM THE PRESENT OR ANY FUTURE EXPIRATION DATE, UNLESS AT LEAST FORTY FIVE (45) DAYS PRIOR TO THE EXPIRATION DATE WE SHALL SEND TO YOU BY OVERNIGHT COURIER, OUR WRITTEN NOTICE THAT WE ELECT NOT TO EXTEND THIS CREDIT FOR ANY SUCH ADDITIONAL PERIOD. SAID NOTIFICATION WILL BE SENT TO THE BENEFICIARY’S ADDRESS INDICATED ABOVE, UNLESS A CHANGE OF ADDRESS IS OTHERWISE NOTIFIED BY YOU TO US IN WRITING BY RECEPTEED MAIL OR OVERNIGHT COURIER, QUOTING OUR LETTER OF CREDIT NUMBER. SAID CHANGE OF ADDRESS NOTIFICATION MUST BE RECEIVED BY THE ISSUER, AT THE ADDRESS SET FORTH ABOVE, OR ON AN AMENDMENT, IF ANY.

B. THIS IRREVOCABLE STANDBY LETTER OF CREDIT IS TRANSFERABLE AND CAN BE SUCCESSIVELY TRANSFERRED TO ANY TRANSFEREE THAT BENEFICIARY STATES IN
WRITING TO US HAS SUCCEEDED AS BENEFICIARY UNDER THIS LETTER OF CREDIT, PROVIDED THAT SUCH TRANSFER TO SUCH TRANSFEREE IS IN COMPLIANCE WITH APPLICABLE U. S. LAWS AND REGULATIONS. THIS LETTER OF CREDIT IS TRANSFERABLE ONLY BY BENEFICIARY. IF TRANSFERRED, THE CREDIT MUST BE RETURNED TO US ALONG WITH ALL AMENDMENTS TOGETHER WITH A TRANSFER REQUEST IN THE FORM ATTACHED HERETO AS “SCHEDULE 2,” DULY EXECUTED. IN CASE OF ANY TRANSFER UNDER THIS IRREVOCABLE STANDBY LETTER OF CREDIT, THE DRAFT MUST BE EXECUTED BY THE TRANSFEREE AND WHERE THE BENEFICIARY’S NAME APPEARS WITHIN THIS IRREVOCABLE STANDBY LETTER OF CREDIT, THE TRANSFEREE’S NAME IS AUTOMATICALLY SUBSTITUTED THEREFOR.

C. IN THE EVENT YOU WISH TO CANCEL THIS IRREVOCABLE STANDBY LETTER OF CREDIT, THIS ORIGINAL LETTER AND ALL AMENDMENTS HERETO MUST BE SUBMITTED TO THE ISSUER, ACCOMPANIED BY YOUR LETTER NOTIFYING US OF YOUR INTENT TO CANCEL.

D. WE ENGAGE WITH YOU THAT THE DRAFT(S) AND OR DOCUMENTS DRAWN UNDER AND IN COMPLIANCE WITH THE TERMS AND CONDITIONS OF THIS IRREVOCABLE LETTER OF CREDIT WILL BE DULY HONORED ON DELIVERY OF DOCUMENTS AT OUR OFFICES AS INDICATED HEREIN.

E. PARTIAL DRAWINGS AND MULTIPLE PRESENTATIONS MAY BE MADE UNDER THIS IRREVOCABLE STANDBY LETTER OF CREDIT, PROVIDED, HOWEVER, THAT EACH SUCH DEMAND THAT IS PAID BY US SHALL REDUCE THE AMOUNT AVAILABLE UNDER THIS IRREVOCABLE STANDBY LETTER OF CREDIT.

F. IN THE EVENT THAT THE ORIGINAL OF THIS IRREVOCABLE STANDBY LETTER OF CREDIT IS LOST, STOLEN, MUTILATED, OR OTHERWISE DESTROYED, WE HEREBY AGREE TO ISSUE A DUPLICATE ORIGINAL HEREOF UPON RECEIPT OF A WRITTEN REQUEST FROM YOU AND A CERTIFICATION BY YOU OF THE LOSS, THEFT, MUTILATION, OR OTHER DESTRUCTION OF THE ORIGINAL HEREOF.

G. THE TERM “BENEFICIARY” INCLUDES ANY SUCCESSOR BY OPERATION OF LAW OF THE NAMED BENEFICIARY INCLUDING, WITHOUT LIMITATION, ANY LIQUIDATOR, REHABILITATOR, RECEIVER, OR CONSERVATOR.

H. EXCEPT AS EXPRESSLY STATED HEREIN, THIS UNDERTAKING IS NOT SUBJECT TO ANY AGREEMENT, CONDITION OR QUALIFICATION. THE OBLIGATION OF THE ISSUER UNDER THIS LETTER OF CREDIT IS THE INDIVIDUAL OBLIGATION OF THE ISSUER, AND IS IN NO MANNER CONTINGENT UPON REIMBURSEMENT WITH RESPECT THERETO.

SCHEDULE 1

TO FORM OF LETTER OF CREDIT

THIS SCHEDULE FORMS AN INTEGRAL PART OF _____________ BANK LETTER OF CREDIT NUMBER _____________

DATE: ____________________________ REF. NO. ________________

AT: ____________________________

PAY TO THE ORDER OF ________________ US$ ________________

USDOLLARS ____________________________

DRAWN UNDER _____________ BANK IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER ________________ DATED ____________

TO: ______________________ BANK

[ADDRESS]

BENEFICIARY’S NAME

_________________________

Authorized Signatory
SCHEDULE 2
TO FORM OF LETTER OF CREDIT

DATE: ____________________, 20___

TO: ____________________ [ISSUER BANK]

ATTN: ____________________

RE: [ISSUER BANK] IRREVOCABLE STANDBY LETTER OF CREDIT NO.

Ladies and Gentlemen:

FOR VALUE RECEIVED, THE UNDERSIGNED BENEFICIARY HEREBY IRREVOCABLY TRANSFERS TO:

______________________________________________________________
(NAME OF TRANSFEREE)

______________________________________________________________
(ADDRESS)

ALL RIGHTS OF THE UNDERSIGNED BENEFICIARY TO DRAW UNDER THE ABOVE IRREVOCABLE LETTER OF CREDIT UP TO ITS AVAILABLE AMOUNT AS SHOWN ABOVE AS OF THE DATE OF THIS TRANSFER.

BY THIS TRANSFER, ALL RIGHTS OF THE UNDERSIGNED BENEFICIARY IN SUCH IRREVOCABLE LETTER OF CREDIT ARE TRANSFERRED TO THE TRANSFEREE. TRANSFEREE SHALL HAVE THE SOLE RIGHTS AS BENEFICIARY THEREOF, INCLUDING SOLE RIGHTS RELATING TO ANY AMENDMENTS, WHETHER INCREASES OR EXTENSIONS OR OTHER AMENDMENTS, AND WHETHER NOW EXISTING OR HEREAFTER MADE. ALL AMENDMENTS ARE TO BE ADVISED DIRECT TO THE TRANSFEREE WITHOUT NECESSITY OF ANY CONSENT OF OR NOTICE TO THE UNDERSIGNED BENEFICIARY.

THE ORIGINAL OF SUCH IRREVOCABLE LETTER OF CREDIT IS RETURNED HEREWITH AND WE ASK YOU TO ENDORSE THE TRANSFER ON THE REVERSE THEREOF, AND FORWARD IT DIRECTLY TO THE TRANSFEREE WITH YOUR CUSTOMARY NOTICE OF TRANSFER. THIS TRANSFER IS AT NO CHARGE TO THE BENEFICIARY OR THE TRANSFEREE.

SINCERELY,

__________________________________________________________
(BENEFICIARY’S NAME)

__________________________________________________________
(SIGNATURE OF BENEFICIARY)

__________________________________________________________
(PRINTED NAME AND TITLE)
APPENDIX B

FORM OF LETTER OF CREDIT AGREEMENT BETWEEN LENDER AND LANDLORD

LETTER OF CREDIT AGREEMENT

THIS LETTER OF CREDIT AGREEMENT (this “Agreement”) is made as of ____________, 20__, by [BORROWER NAME], a ______________ (“Borrower”), in favor of [LENDER NAME], a ______________ (“Lender”), with reference to the following facts:

A. Lender has made a loan to Borrower in the amount of $______________ (the “Loan”).

B. The Loan is evidenced by (i) that certain Promissory Note dated ______________ (the “Note”), in the original principal amount of $______________ from Borrower and payable to and for the benefit of Lender.

C. Payment of the Note is secured by, among other things, that certain [Deed of Trust and Security Agreement] [Mortgage] dated ______________, executed by Borrower, as Trustor, to ______________, a ______________, as Trustee, for the benefit of Lender, and recorded ______________, as Instrument No. ______________ in the Official Records of ______________ County, ______________ (the “Mortgage.”) The Mortgage encumbers an estate in certain real property located in ______________, ______________, known as ______________ and more particularly described therein, together with certain other personal property and other property as set forth therein (collectively, the “Property”). A portion of the Loan was advanced to Borrower under a Loan Agreement dated as of ______________ (the “Loan Agreement”).

D. The Note, the Loan Agreement, the Mortgage and all other documents evidencing or securing the Loan are referred to herein collectively as the “Loan Documents.”

E. Borrower is the landlord under a certain Lease dated ______________, 20__ (the “Lease”) wherein ______________, a ______________ (“Tenant”), is the tenant, covering certain premises located at ______________. Pursuant to the Lease, Tenant has provided that certain Irrevocable Standby Letter of Credit No. ______________ dated ______________, 20__ (the “Original Letter of Credit”) issued by ______________ (“Issuer”), in the amount of $______________ in favor of [LENDER NAME], a ______________, as beneficiary. Tenant is the Applicant under the Original Letter of Credit, and Lender is the beneficiary of the Original Letter of Credit.

F. As a condition to waiving its right under the Loan Documents to approve the Lease, Lender requires that Borrower execute this Agreement.

NOW, THEREFORE, in consideration of the foregoing and other good and valuable consideration, the receipt and legal sufficiency of which are hereby acknowledged and
intending to be legally bound hereby, to secure the payment of the Loan, together with all interest thereon, as evidenced by the Note, any other payments due to Lender under this Agreement, the Note, the Mortgage or any other Loan Document, all costs of collection in connection with the Loan, and all other sums, charges, obligations and liabilities of Borrower due or to become due at any time to Lender under this Agreement, the Note, or any other Loan Document; and to secure the performance and observance of all the provisions hereof, of the Note, of the Mortgage, and of the other Loan Documents, including, without limitation, the payment to Lender of the Loan and any other sums advanced by Lender hereunder or under any other Loan Document, Borrower hereby agrees as follows:

1. Delivery of Letter of Credit to Lender.

   (a) Concurrently herewith, Borrower shall cause the Issuer to deliver the Original Letter of Credit to Lender. After the date hereof, Borrower shall deliver (or cause the Issuer to deliver) to Lender any letter of credit issued in substitution or replacement of the Letter of Credit (as defined below), or any amendments to the Letter of Credit, including without limitation any replacement letter of credit or any amendments to or renewals of the Letter of Credit issued in connection with any reduction, increase, or modification as permitted or required under Section ____ of the Lease (the “L/C Modification Provisions”), all to be held by Lender in the same manner as with respect to the Original Letter of Credit. The Original Letter of Credit, any subsequent letter of credit or letters of credit issued in substitution, replacement, or renewal of the Original Letter of Credit, and/or any amendments thereto are referred to herein as the “Letter of Credit.” The term “L/C Amendment” as used herein means the new letter of credit instruments which effectuate any reduction or increase in the amount of the Letter of Credit as required under the Lease and this Agreement, including (i) an amendment to the then-existing Letter of Credit increasing or decreasing the amount of the Letter of Credit, (ii) an additional letter of credit which, when combined with the then existing Letter of Credit is in the increased aggregate amount then required under the terms of the Lease, or (iii) a substitution and replacement of the Letter of Credit in the aggregate amount then required under the terms of the Lease.

   (b) Upon the occurrence of any event contemplated under the L/C Modification Provisions and prior to the Issuer’s issuance of any L/C Amendment, Borrower shall comply with the following, all of which shall be satisfactory to Lender in its reasonable discretion:

   (i) Within five (5) days after Borrower’s receipt of Tenant’s delivery of any of the items required under Section ____ of the Lease in connection with the Reduction Conditions identified in Section ____ of the Lease, Borrower shall deliver copies thereof to Lender and shall certify to Lender that Tenant is not in default under the Lease (beyond any applicable notice and cure period set forth in the Lease). Borrower shall also immediately provide copies of such information and documents received from Tenant and shall provide any information and documents relating thereto as Lender may reasonably request. Within seven (7) business days after Lender’s receipt of such written notice, together with all other items required to be delivered by Tenant under the Lease and all other items required to be delivered by Borrower pursuant to this Agreement in connection therewith, Lender shall either
(A) confirm satisfaction of the Reduction Conditions identified in Section ____ of the Lease, or
(B) deliver to Borrower written notice specifying the reasons that such confirmation cannot be
made. If Lender has not responded to such written notice with such seven (7) business day
period, satisfaction of the Reduction Conditions shall be deemed to be confirmed.

(ii) Within five (5) days after Borrower’s receipt of any notice
from Tenant of Tenant’s election to exercise its right to lease particular First Offer Space (as
such term is defined in the Lease), Borrower shall notify Lender in writing and shall deliver to
Lender a copy of the notice and all related documents received from Tenant. Thereafter,
Borrower shall also provide all information and documents relating thereto as Lender may
reasonably request. Concurrently with such delivery, Borrower shall inform Lender in writing
of the amount of increase to the L-C Amount (as defined in the Lease) as set forth in Section ____
of the Lease, which increase shall be determined by Borrower in accordance with the terms set
forth in the Lease. Without the prior written approval of Lender, Borrower shall not enter into
the applicable amendment to the Lease; provided, however, that Borrower may enter into such an
amendment without Lender’s prior approval provided that the amendment is solely to implement
(A) the increase of the amount of the Letter of Credit and (B) the addition of the First Offer
Space, all strictly in accordance with the Lease and with respect to no other matters, and further
provided that Lender receives the applicable L/C Amendment concurrently with the execution of
such amendment to the Lease.

(c) In the event of any reduction or increase in the Letter of Credit
pursuant to subparagraph (b) above (subject to Lender’s approval where required), Borrower
shall cause Tenant to have the applicable L/C Amendment issued in the name of Lender as
Beneficiary and shall cause Tenant to deliver the L/C Amendment to Lender concurrently with
Tenant’s execution of the applicable amendment to the Lease. Lender shall return the Letter of
Credit being replaced (including any prior L/C Amendment) to Borrower (or at Lender’s option,
directly to Tenant) at such time as Borrower is required to release or return such Letter of Credit
(including any such L/C Amendment) to Tenant pursuant to the Lease, and shall cooperate with
the Issuer in connection with the Issuer’s reasonable requirements with respect to the issuance of
such L/C Amendment. The foregoing obligations of Lender are conditioned upon Lender,
Borrower, and the Issuer mutually agreeing to a procedure for exchanging any Letter of Credit or
L/C Amendment in a manner that will protect the rights of all parties.

2. L/C Draw Event under the Lease. Borrower shall provide written notice
to Lender immediately upon the occurrence of an event permitting Borrower to draw upon the
Letter of Credit under Section ____ of the Lease (an “L/C Draw Event”). If Borrower elects to
exercise its rights under the Lease to draw upon the Letter of Credit, Borrower shall notify
Lender of such election in writing (“Borrower’s L/C Draw Notice”) and shall provide all
information and documents relating thereto as Lender may reasonably request, including without
limitation a certification to Lender substantially in the form of Schedule 1 hereto executed by
Borrower that Borrower is entitled to draw upon the Letter of Credit, stating the reason or
reasons therefor, the amount of the draw, and otherwise in form reasonably satisfactory to
Lender. In connection therewith, subject to the provisions hereof, Borrower does hereby
authorize, direct, and empower Lender, its successors and assigns, at Lender’s option, to collect
or enforce the Letter of Credit in accordance with the provisions of the Lease. Within five (5)
business days after receipt by Lender of Borrower’s L/C Draw Notice, Lender shall take such steps as are reasonably necessary to draw upon the Letter of Credit in such amount as Borrower determines pursuant to the Lease is necessary to cure the L/C Draw Event. Borrower acknowledges that Lender shall require the Issuer to deposit all L/C Proceeds into such account (the “L/C Escrow Account”) as Lender shall designate, which may (at the option of Lender) be an account in the name of Lender. Lender may commingle the deposits with other funds of Lender. Lender shall have no obligation to credit Borrower with any interest on the funds held in the L/C Escrow Account. Borrower acknowledges and agrees that absent the active negligence, gross negligence, or willful misconduct of Lender, all risk of loss with respect to the principal amount of such deposits shall be at the sole risk of Borrower. Borrower further acknowledges and agrees to be fully responsible for any and all fees charged by any depository institution holding any L/C Proceeds. Borrower hereby knowingly, voluntarily and intentionally stipulates, acknowledges and agrees that the disbursement of the funds from the L/C Escrow Account as set forth herein is at Borrower’s direction and is not the exercise by Lender of any right of set-off or other remedy upon a default or an Event of Default under the Loan Documents. Until such time as this Agreement is released in accordance with Section 15 hereof, Borrower hereby waives all right to draw upon the Letter of Credit and to withdraw funds from the L/C Escrow Account except as provided for herein. The L/C Escrow Account entails no responsibility on Lender’s part beyond compliance with the terms of this Agreement, including without limitation the payment of the items for which the L/C Escrow Account is held in accordance with the Lease and the terms hereof and beyond the allowing of due credit for the sums actually received.

3. Release of L/C Proceeds if no Default under the Loan. So long as no Event of Default or any circumstance or event which with the passage of time and/or notice would constitute an Event of Default under the Loan Documents (a “Loan Default”) exists, the L/C Proceeds shall be held in the L/C Escrow Account and/or disbursed by Lender as set forth in this Section. Lender shall disburse the L/C Proceeds to Borrower; provided, however, that:

   (a) If the L/C Proceeds exceed the amount required to cure all defaults by Tenant under the Lease, or any claim allowed Borrower in connection with such default, only the amount or amounts required to effectuate such cure or satisfy such claim as reasonably determined by Lender from time to time shall be disbursed to Borrower; and

   (b) If the Lease has been terminated for any reason, Lender shall disburse the L/C Proceeds to Borrower to pay for costs and expenses incurred by Borrower for capital improvements, leasing commissions, and any other re-tenanting costs (including any capital improvements made on a speculative basis, including to create additional suites, or to cause areas of the Property to be useable for leasing on a multi-tenant basis) in connection with leasing of the Property, pursuant to the procedures set forth in Section ____ of the Loan Agreement.

In the event of any termination of the Lease, and provided that all of the space covered by the Lease has been re-leased to one or more tenants who have taken possession of such space on a full rent-paying basis pursuant to one or more leases that comply with the Leasing Guidelines (as defined ________), (as evidenced by tenant estoppel certificates reasonably satisfactory to Lender), any remaining amounts not disbursed pursuant to the foregoing shall be disbursed to Borrower (subject to the rights of Tenant under the Lease). Otherwise, any such remaining
amounts shall be held as cash collateral for Borrower’s obligations under the Loan Documents (subject to the rights of Tenant under the Lease). If at the time of a draw upon the Letter of Credit there has occurred a Loan Default, Lender shall disburse the L/C Proceeds (or so much thereof as shall remain after application in the manner set forth in Section 5 below) to Borrower only after the complete cure of such Loan Default in accordance with the terms of the Loan Documents.

4. Disposition of L/C Proceeds if Loan Default. Notwithstanding any other provision hereof, but subject to the rights of Tenant under the Lease, if, at the time there is a draw upon the Letter of Credit or at any time thereafter prior to the L/C Proceeds being disbursed to Borrower pursuant to Section 4 above, there shall exist a Loan Default, Lender may without notice or demand on Borrower, at Lender’s option (subject to the rights of Tenant under the Lease): (a) apply the L/C Proceeds (which shall be deemed to be cash collateral for Borrower’s obligations under the Loan Documents), after deducting all costs and expenses of safekeeping, collection and delivery (including, but not limited to, reasonable attorneys’ fees, costs and expenses) to the Indebtedness (as defined in the Note) or any other obligations of Borrower under the Loan Documents in such manner as Lender shall deem appropriate in its sole discretion, and the excess, if any, shall be paid to Borrower, (b) exercise any and all rights and remedies of a secured party under the California UCC, and/or (c) exercise any other remedies available at law or in equity. No delay or omission of Lender in exercising any right to draw on the Letter of Credit shall impair any such right, or shall be construed as a waiver of or acquiescence in any event giving rise to such right.

5. Grant of Security Interest. Subject to the rights of Tenant under the Lease, and as additional security for the payment and performance by Borrower of its obligations under this Agreement and the other Loan Documents, Borrower hereby unconditionally and irrevocably assigns, conveys, pledges, mortgages, transfers, delivers, deposits, sets over and confirms unto Lender, and hereby grants to Lender a continuing security interest in any and all of Borrower’s interest in, (a) the Letter of Credit and all proceeds (the “L/C Proceeds”) under the Letter of Credit, whether as the result of partial drawings thereunder or otherwise, (b) the account or accounts into which the L/C Proceeds have been or may be deposited, (c) all insurance on said accounts, (d) all accounts, contract rights and general intangibles or other rights and interests pertaining thereto, (e) all sums now or hereafter therein or represented thereby, (f) all replacements, substitutions or proceeds thereof, (g) all instruments and documents now or hereafter evidencing the L/C Proceeds or such accounts, (h) all powers, options, rights, privileges and immunities pertaining to the L/C Proceeds or such accounts (including the right to make withdrawals therefrom), and (i) all proceeds of the foregoing. Borrower hereby authorizes and consents to the accounts into which the L/C Proceeds have been or may be deposited being held in Lender’s name or the name of any entity servicing the Note for Lender and hereby acknowledges and agrees that Lender, or at Lender’s election, such servicing agent, shall have exclusive control over said accounts, subject, however, to the other provisions of this Agreement. Notice of the assignment and security interest granted to Lender herein may be delivered by Lender at any time to the financial institution wherein such accounts have been established, and Lender, or such servicing entity, shall have possession of all passbooks or other evidences of such accounts. Notice of the assignment and security interest granted to Lender herein may also be delivered by Lender at any time to the Issuer. This Agreement is intended by Borrower and
Lender to create, and shall be construed to create, an absolute assignment to Lender, subject only to the terms and provisions of this Agreement. This assignment is effective immediately.

6. Rights and Remedies. The rights and remedies granted Lender under this Agreement are supplemental to, and not in limitation of, the rights and remedies of Lender under applicable law, and all such rights and remedies are not exclusive of one another, but rather are cumulative and may be pursued simultaneously. This Agreement is not intended to modify or amend any of the obligations of Borrower or the rights or remedies of Lender under any of the other Loan Documents.

7. Commingling of Funds. Any L/C Proceeds being held by Lender shall not, unless otherwise explicitly required by applicable law, be or be deemed to be escrow or trust funds, but, at Lender’s option and in Lender’s discretion, may either be held in a separate account or be commingled by Lender with the general funds of Lender. The Letter of Credit and the L/C Proceeds are for the protection of Borrower and Lender (subject however to the rights of Tenant); nevertheless, they shall entail no responsibility on Lender’s part beyond the release and/or disbursement thereof in accordance with the terms hereof and beyond the allowing of due credit for the sums actually received.

8. Representations of Borrower. Borrower hereby represents and warrants to Lender as follows:

(a) Borrower has not executed any prior assignment or pledge of its interest in the Letter of Credit or the L/C Proceeds, nor performed any act or executed any other instrument which might prevent Lender from operating under any of the terms and conditions of this Agreement, or which would limit or hinder Lender in such operation.

(b) Borrower has delivered to Lender a true, correct and complete copy of the Lease including all amendments thereto. The Lease is in full force and effect with no defaults by Borrower or Tenant thereunder.

9. No Further Assignments. Borrower hereby agrees that so long as the Indebtedness, or any part thereof, shall remain unpaid, without the prior written consent and approval of Lender in each instance, Borrower will not assign, pledge, hypothecate or otherwise encumber any of its rights under the Letter of Credit or any of its interest in the L/C Proceeds.

10. Borrower Undertakings. Borrower agrees that at its sole expense it will (a) not terminate, accept a voluntary surrender of, cancel, abridge, otherwise modify or waive its rights or the obligations of any party under the Letter of Credit, without the express written consent of Lender; (b) use its commercially reasonable efforts to cause Tenant to maintain the Letter of Credit in full force and effect and/or to increase or otherwise amend the Letter of Credit and to otherwise comply with the provisions of the Lease relating to the Letter of Credit; (c) appear in and defend any action or proceeding arising under or in any manner related to the Letter of Credit, except to the extent arising out of Lender’s active negligence, gross negligence or willful misconduct; and (d) take all additional action to these ends as from time to time may be reasonably requested in writing by Lender. Any action taken by Borrower in violation of this Section shall be voidable at the option of Lender.
11. **Indemnification.** Except as may be specifically set forth herein, Lender shall not be obligated to perform or discharge any obligation of Borrower as a result of the assignment hereby effected. Borrower agrees to protect, indemnify, defend and hold Lender harmless against any and all claims, demands, actions, liability, loss, cost, damage or expense (including reasonable attorneys’ fees and expenses) arising out of or relating to this Agreement, except to the extent arising out of Lender’s active negligence, gross negligence or willful misconduct. Should Lender incur any such liability, loss, cost, damage or expense by reason of this Agreement, or in defense against any such claims, demands, or actions, the amount thereof, including costs and expenses, reasonable attorneys’ fees and disbursements, together with interest thereon at the rate of ______________ percent (_____%) per annum shall be included in the Indebtedness, and Borrower shall reimburse Lender therefor immediately upon demand. The obligations of Borrower under this Section shall survive the payment in full of the Loan and the termination of this Agreement.

12. **Further Assurances.** Borrower shall at its sole cost and expense do, execute, acknowledge and deliver all further acts, assurances, authorizations, documents or instruments as Lender may reasonably request to effect further or confirm the purposes of this Agreement. If Borrower fails to comply with the terms of this Section after written notice and five (5) days’ opportunity to cure, Lender may, at Borrower’s expense, perform Borrower’s obligations for and in the name of Borrower, and Borrower hereby irrevocably and unconditionally appoints Lender as its attorney-in-fact, with full power of substitution, to do so. Such appointment of Lender as attorney-in-fact is coupled with an interest.

13. **No Mortgagee-in-Possession.** Nothing herein contained shall be construed as making Lender or its successors and assigns a mortgagee-in-possession.

14. **Borrower Not Released.** Neither the execution of this Agreement nor any action or inaction on the part of Lender under this Agreement shall release Borrower from any of its obligations under the Lease or constitute an assumption of any such obligations on the part of Lender, provided, however, that at all times Lender shall hold the Letter of Credit and the L/C Proceeds subject to the rights of Tenant. No action or failure to act on the part of Borrower shall adversely affect or limit, in any way, the rights of Lender under this Agreement, the other Loan Documents, or the Lease. Neither the existence of this Agreement nor the exercise of its privilege to require Borrower to obtain, collect or enforce the Letter of Credit hereunder shall be construed as a waiver by Lender or its successors and assigns of the right to enforce payment of the Indebtedness in strict accordance with the terms and provisions of the Note, the other Loan Documents.

15. **Release.** This Agreement shall be released (without the need to execute any further instruments) upon the earlier to occur of (a) the full release and reconveyance of the Mortgage or (b) the expiration of the Lease in accordance with its terms. Upon such release, the Letter of Credit and all L/C Proceeds shall be delivered or paid to Borrower, provided, however, that in the event that the Lease, as amended or modified from time to time in accordance with the Loan Documents, requires that the Letter of Credit and/or the L/C Proceeds be returned to Tenant, Lender shall return the Letter of Credit and and/or the L/C Proceeds to Tenant promptly upon written request from Borrower.
16. **Successors and Assigns.** The terms and provisions hereof shall be binding upon and inure to the benefit of Borrower and Lender and their respective successors and permitted assigns, whether by voluntary action of the parties or by operation of law. Borrower shall have no right to assign its rights and/or obligations under this Agreement and any such attempted assignment shall be null and void and shall constitute an Event of Default under the Mortgage. As used herein, the terms “Borrower” and “Lender” shall be deemed to include their respective successors and permitted assigns, whether by voluntary action of the parties or by operation of law. In the event of the sale or transfer of Lender’s interest in the Loan, Lender shall have the right to assign this Agreement and transfer the Letter of Credit and any L/C Proceeds (or any remaining portion thereof) to the transferee, and Borrower agrees to fully cooperate with Lender in connection therewith (including the execution of any required documents). Borrower shall look only to the new lender for the performance of the obligations of Lender, and Lender shall have no further obligations hereunder except as a result of any breach of this Agreement by Lender occurring prior to the date of transfer of Lender’s interest in the Loan. Any duties or actions of Lender hereunder may be performed by Lender or its agent(s), including without limitation, any servicer of the Loan.

17. **Notices; Choice of Law.** All notices hereunder shall be given in the same manner as set forth in the Mortgage. This Agreement shall be governed by the internal laws of the State of _______________-without regard to conflicts of laws.

18. **Costs and Expenses.** Borrower shall be responsible for, and hereby agrees to pay, (a) the actual costs and expenses of Lender’s counsel incurred in connection with the negotiation and execution of this Agreement, and (b) all costs and expenses (including without limitation reasonable attorneys’ fees, if any) incurred by Lender in connection with the enforcement of this Agreement, including, without limitation, (i) all costs and expenses incurred in connection with the Letter of Credit (including, without limitation, any penalty or charge assessed by the Issuer for any drawings on the Letter of Credit and which is not reimbursed by Tenant), and (ii) all actual costs and expenses (including without limitation, reasonable processing fees, the fees and costs of any servicer or other contractor engaged by Lender, and reasonable attorneys’ fees, if any) incurred by Lender or any such servicer or contractor in connection with Lender’s consideration of or implementation of any drawings, amendments, substitutions, replacements, or other modifications of the Letter of Credit (or Borrower’s or Tenant’s requests therefor) under any provision of this Agreement. All such costs and expenses, if not paid by Borrower within ten (10) days after request therefor, shall bear interest at the rate __________ percent (____%) per annum from the date of expenditure by Lender until reimbursement by Borrower, and may be paid by Lender from any cash collateral held by Lender under any of the Loan Documents at any time without the consent of Borrower.

19. **Default.** If Borrower shall fail to timely and fully perform any of its obligations under this Agreement for a period of more than ten (10) days after receipt of notice of such failure from Lender, then any such failure shall constitute an Event of Default under this Agreement and an Event of Default under the Mortgage. The occurrence of an “Event of Default” under and as defined in the Mortgage or any other Loan Document shall constitute an automatic Event of Default under this Agreement.
20. **No Third-Party Beneficiaries.** It is the intention of the parties hereto that this Agreement is made for the benefit of Lender, who shall have the sole right to enforce the provisions hereof. In no event shall Lender be construed to be Borrower’s agent, and in no event is Lender assuming the responsibility of Borrower for proper payments to others. It is intended that no party shall be a third-party beneficiary hereunder and that no provision hereof shall operate or inure to the use or benefit of such third party.

21. **Attorneys’ Fees.** In the event that any party brings any suit or other proceeding with respect to the subject matter or enforcement of this Agreement, including without limitation, in appellate proceedings or in any action or participation in, or in connection with, any case or proceeding under Chapter 7, 11 or 13 of the Bankruptcy Code, 11 United States Code Sections 101 et seq., or any successor statutes, the prevailing party (as determined by the court, agency or other authority before which such suit or proceeding is commenced) shall, in addition to such other relief as may be awarded, be entitled to recover reasonable attorneys’ fees, expenses and costs of investigation.

22. **Counterparts.** This Agreement may be executed in one or more counterparts, each of which shall be deemed an original.

23. **Miscellaneous.** If for any reason any provision of this Agreement shall be held to be invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby. Titles of paragraphs and sections are for convenience only and in no way define, limit, amplify or describe the scope or intent of any provisions hereof. Time is of the essence with respect to all provisions of this Agreement.

IN WITNESS WHEREOF, Borrower and Lender have executed this Letter of Credit Agreement as of the date first above written.

[LENDER NAME]
By _____________________
Name ___________________
Its _____________________

[BORROWER NAME]
By _____________________
Name ___________________
Its _____________________
SCHEDULE 1

TO FORM OF LETTER OF CREDIT AGREEMENT

Form of Borrower Certification under Section 3

BORROWER’S L/C DRAW NOTICE AND CERTIFICATE

Date: __________

[LENDER NAME]
[LENDER CONTACT]

RE: Letter of Credit Agreement dated ______________ (the “LOC Agreement”), by and between ______________, a ______________ (“Borrower”), and ______________, a ______________ (“Lender”); Lease dated ______________, between ______________, a ______________, as Landlord, and ______________, a ______________ (“Tenant”), as Tenant; Irrevocable Standby Letter of Credit ______________ issued by ______________ dated ______________ (the “Letter of Credit”)

Ladies/Gentlemen:

Borrower hereby notifies Lender that the following L/C Draw Event (as that term is defined in the LOC Agreement) has occurred: ____________________________________________

[Provide full details and attach all relevant documents].

Borrower hereby certifies to Lender that as a result of such L/C Draw Event, Borrower has the right under the terms of the Lease to draw upon the Letter of Credit in the amount of $__________.

Borrower hereby elects to exercise its rights under the Lease to draw upon the Letter of Credit in the amount set forth above, and accordingly, this letter shall constitute a Borrower’s L/C Draw Notice as required under the terms of Section 2 of the LOC Agreement.

IN WITNESS WHEREOF, the undersigned has executed this certificate as of the date first set forth above.

[BORROWER NAME],
a ______________

By: ______________________________
Name: ______________________________
Its: ______________________________