



CLIENT ALERT

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Recent Letter of Credit Cases:

In re Stonebridge Technologies, Inc., 430 F.3d 260 (5th Cir. 2005)

In re Spring Ford Indus., Inc., No. 02-1501 DWS, 04-0479, 05-2549, 2006 WL 273610 (E.D. Pa. Feb. 2, 2006)

Below for your information are summaries of two recent cases involving letters of credit. Generally speaking, the court in *In re Stonebridge Technologies, Inc.*, 430 F.3d 260 (5th Cir. 2005), permitted a landlord to draw the full amount available under a letter of credit held to secure a debtor lessee's performance under a lease instead of limiting the amount available under the letter of credit to the statutory cap on lease rejection damages in Section 502(b)(6) of the Bankruptcy Code. The court in *In re Spring Ford Indus., Inc.*, No. 02-1501 DWS, 04-0479, 05-2549, 2006 WL 273610 (E.D. Pa. Feb. 2, 2006), found that funds drawn by a beneficiary of a letter of credit in excess of the amount owed by an account party debtor to the beneficiary were property of the account party debtor's bankruptcy estate and required the turnover of such excess funds to the debtor instead of the letter of credit bank.

In re Stonebridge Technologies, Inc.

The Fifth Circuit Court of Appeals in *In re Stonebridge Technologies, Inc.* permitted a landlord to draw and retain the full amount available under a letter of credit securing a debtor lessee's performance under a lease. The court distinguished holdings of two other courts to the effect that such a draw should be treated like a cash security deposit and limited to the statutory cap on lease rejection damages in Section 502(b)(6) of the Bankruptcy Code. The Fifth Circuit declined to limit the landlord's draw under the letter of credit to the statutory cap on damages that could be sought against the debtor lessee because the landlord looked solely to the letter of credit and did not file a proof of claim in the debtor lessee's bankruptcy case.

In *In re Stonebridge Technologies, Inc.*, Stonebridge Technologies ("Stonebridge") leased office space from EOP-Colonnade of Dallas Limited Partnership ("EOP"). The lease allowed EOP to accelerate all amounts due upon a default by Stonebridge. Stonebridge provided a letter of credit to EOP to secure its performance under the lease. Stonebridge subsequently failed to make certain lease payments under the lease, filed bankruptcy and rejected the lease. Based on Stonebridge's monetary defaults under the lease, EOP made a draw under the letter of credit for the total stated amount. The amount drawn by EOP under the letter of credit was insufficient to fully reimburse EOP for the total amount of its damages due from Stonebridge's rejection of the lease, but such draw reimbursed EOP for substantially all of its damages and EOP did not file a proof of claim in Stonebridge's bankruptcy case.

The debtor lessee asserted, and the bankruptcy court held, that EOP should not be entitled to retain the full stated amount of the letter of credit, but should instead be limited by the statutory cap on lease rejection damages under Section 502(b)(6) of the Bankruptcy Code.¹ The bankruptcy court reasoned that the amount available to EOP under the letter of credit should be limited by this capped amount because the letter of credit constituted part of

Stonebridge's security deposit and was thus subject to treatment as a security deposit under Section 502(b)(6).² The bankruptcy court further held that EOP's draw under the letter of credit securing the lease was improper because at the time of the draw no amount was "due and owing" to EOP by Stonebridge under the lease.³ The district court affirmed the bankruptcy court.

On appeal, the Fifth Circuit reversed the district court in holding that the Section 502(b)(6) cap on a landlord's damages for rejection of its lease should not limit the amount available to the landlord under the letter of credit in this case. The court reasoned:

By its terms, § 502(b) applies only to claims against the bankruptcy estate.... Claims under § 502(b) are not automatically assumed simply because the debtor assumes or rejects a lease under § 365, but rather must be formally filed against the estate in the bankruptcy court.... Stated simply, the claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all.... Thus, the damages cap of § 502(b)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter of credit unless and until the lessor makes a claim against the estate. We find, therefore, that further inquiry into the appropriate interpretation of § 502(b)(6) is unnecessary in this case because EOP did not file a claim against the estate.

In re Stonebridge Technologies, Inc., 430 F.3d at 269 (citations omitted). Accordingly, because EOP asserted a claim solely against a third-party obligor (the letter of credit bank) and not against the debtor, EOP was not limited by the Section 502(b)(6) cap in calculating its damages that were due under the letter of credit.⁴

The Fifth Circuit distinguished two other decisions that treated a letter of credit securing a debtor lessee's performance under a lease as a security deposit posted by the debtor lessee and thus subject to the cap on a landlord's claim under Section 502(b)(6). See *In re PPI Ent., Inc.*, 324 F.3d 197 (3 Cir. 2003); *In re Mayan Networks Corp.*, 306 B.R. 295 (B.A.P. 9th Cir. BAP 2004). The Fifth Circuit noted that the landlords in both of those cases, unlike the landlord in *In re Stonebridge Technologies, Inc.*, filed a claim in the debtor lessee's bankruptcy case seeking to recover lease rejection damages in excess of the amount of the security deposit posted by the debtor lessee.⁵

It is also important to note that the letter of credit bank in *In re Stonebridge Technologies, Inc.* was secured by a certificate of deposit pledged by the debtor to reimburse the bank for any draws under the letter of credit. The letter of credit bank and the debtor entered into an agreement allowing the bank to retain its collateral in exchange for an assignment of the bank's claims against EOP for an allegedly improper draw on the letter of credit. These claims that would otherwise have been held by the bank were among those asserted by the debtor against EOP and rejected by the Fifth Circuit.⁶

It is not clear whether the holding in *In re Stonebridge Technologies, Inc.* will be followed in other jurisdictions or in the Third and Ninth Circuits (in which the *In re PPI Ent., Inc.* and *In re Mayan Networks Corp.* cases were decided) if a landlord were to forgo filing a proof of claim in a debtor lessee's bankruptcy. However, based on the *In re Stonebridge Technologies, Inc.* holding, landlords secured by letters of credit should carefully consider whether they should file a proof of claim in a debtor lessee's bankruptcy case, especially if the letter of credit would result in a greater recovery than an unsecured claim against the debtor lessee under Section 502(b)(6).⁷

In re Spring Ford Indus., Inc.

The United States District Court for the Eastern District of Pennsylvania recently held, in *In re Spring Ford Indus., Inc.*, that funds drawn by a beneficiary under a letter of credit in excess of the amount owed by an account

party debtor to such beneficiary constituted property of the account party debtor's bankruptcy estate rather than property of the letter of credit bank. Based on such holding, the court required such excess funds to be turned over to the debtor.

In *In re Spring Ford Indus., Inc.*, Spring Ford Industries ("Spring Ford") self-insured its workers' compensation obligations rather than obtaining insurance from a third party. As required by the Pennsylvania Bureau of Worker's Compensation (the "Bureau"), Spring Ford secured payment of its workers' compensation obligations by obtaining a letter of credit in favor of the Bureau. The letter of credit, issued by PNC Bank ("PNC"), provided that it would be honored upon presentment of a draw by the Bureau and without any other condition.

Spring Ford and the Bureau entered into a trust agreement under which a trust account was created by the Bureau to hold any proceeds of a draw under the letter of credit. Funds in the Bureau's trust account would be held by the Bureau to secure payment of Spring Ford's workers' compensation obligations. The trust agreement provided Spring Ford with a reversionary or residual interest in any funds remaining in the trust account upon the satisfaction of all of Spring Ford's workers' compensation obligations. PNC was not a party to, and did not have any rights under, the trust agreement.

The Bureau drew the entire amount available under the letter of credit upon learning that the letter of credit would expire and that PNC would not renew the letter of credit. The Bureau deposited all proceeds of the draw into the trust account pursuant to the trust agreement. Spring Ford subsequently filed for bankruptcy, the Bureau used funds in the trust account to fully satisfy all of Spring Ford's workers' compensation obligations and approximately \$440,000 of excess letter of credit proceeds remained on deposit in the trust account.

PNC asserted that all funds in excess of the amount owed by Spring Ford to the Bureau should be distributed to PNC rather than the debtor. PNC noted the well-settled law that letters of credit create an independent obligation of the issuing bank to the beneficiary, commonly referred to as the "independence principle," and that proceeds of letters of credit are not considered property of an account party such as Spring Ford. PNC thus argued that all excess proceeds of its letter of credit remaining in the Bureau's trust account should not be considered property of Spring Ford's bankruptcy estate and should be returned to PNC. The effect of such a return to PNC would have reduced, rather than increased, PNC's unsecured claim in Spring Ford's bankruptcy case. However, the bankruptcy court in Spring Ford's bankruptcy case disagreed with PNC and required all excess letter of credit proceeds to be turned over to the debtor.

On appeal, the district court affirmed the bankruptcy court. The district court held that all funds on deposit in the Bureau's trust account constituted property of Spring Ford's bankruptcy estate. While the court agreed with PNC with respect to the application of the independence principle to letters of credit, the court stated that PNC's letter of credit had been fully performed, funds had been properly paid to the Bureau as beneficiary under the letter of credit and that the letter of credit therefore no longer governed the status of the draw proceeds. The court reasoned that:

Under the independence principle, the Letter of Credit is independent from the Trust Agreement. In accordance with the terms of the Letter of Credit, the Bureau called for payment of the entire amount allowed. There were no restrictions on its draw. The Letter of Credit did not condition the granting of the funds on the return or other constrained treatment of the Excess. Likewise, it did not dictate how the Bureau was to spend the proceeds. Once PNC honored the Letter of Credit, that contract between it and the Bureau was fulfilled.... The Bureau deposited the funds into the Trust, and it is the Trust Agreement

that dictates the precise way the funds are supposed to be used. Thus, because PNC cannot control the use of the funds after it performs under the Letter of Credit, the only vehicle that could transport the “excess funds” back to PNC is the Trust Agreement, but only if it grants to PNC such an interest.

In re Spring Ford Indus., Inc., 2006 WL 273610, at *4 (citations omitted).

In response to PNC’s additional argument that requiring a turnover of excess letter of credit proceeds to the debtor would be inequitable and result in a windfall to the debtor, the court referred to PNC as a sophisticated party demonstrating a “situationally unwelcome sophistication.” The court noted that PNC could have taken steps to protect itself and quoted the following passage on this point from the bankruptcy court’s decision:

Such a result may, at first blush, seem to provide an inequitable windfall to Debtor given that the clear purpose of the Letter of Credit was to fund workers’ compensation claims. It cannot be forgotten, however, that PNC is a sophisticated entity. It could have protected itself in any number of ways, including (1) inserting language in the Letter of Credit that limited the Bureau’s draw to anticipated workers’ compensation claims and costs or requiring refund of any excess; (2) inserting language in the Trust Agreement calling for its own right of reversion to unused Letter Proceeds; or (3) contracting with Debtor for a security interest in other assets.

In re Spring Ford Indus., Inc., 2006 WL 273610, at *7.

Based on the *In re Spring Ford Indus., Inc.* decision, it may be prudent for issuers of letters of credit or other credit enhancement instruments, where applicable, to expressly limit draws to the actual unpaid amount owed by the account party or obligor to the beneficiary (which could be the subject of a certification by the beneficiary in the applicable draw requests)⁸ or take the alternate steps set forth in the quoted passages set forth above.

(Endnotes)

¹ Section 502(b)(6) of the Bankruptcy Code limits the amount of the claim a landlord may assert against a debtor lessee in a debtor lessee’s bankruptcy case based on the debtor lessee’s rejection of a lease. Generally speaking, this Section limits a landlord’s damage claim for the debtor lessee’s rejection of a lease to “the rent reserved under such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease” following the earlier of the date the bankruptcy case was filed or the date the landlord repossesses the leased property. This statutory limitation on a landlord’s claim is designed to prevent a potentially very large claim for lease rejection damages from receiving an unfair share of the total amount available to all unsecured creditors.

² In essence, the bankruptcy court held that the amount of a debtor lessee’s security deposit that exceeds a landlord’s capped damages under Section 502(b)(6) cannot be retained by the landlord as an offset against the landlord’s total damages, regardless of whether the security deposit is in the form of cash or a letter of credit. Instead, the amount of a security deposit in excess of the Section 502(b)(6) capped amount, even if the security deposit is in the form of a letter of credit posted by a debtor lessee, must be returned to the bankruptcy estate.

³ The debtor asserted, and the bankruptcy court agreed, that EOP drew on the letter of credit before the lease was rejected and thus no damage amount was yet due and owing to EOP.

⁴ The Fifth Circuit also rejected the bankruptcy court’s conclusion that EOP prematurely drew on the letter of credit before the lease was rejected. The Fifth Circuit concluded that the draw was proper because the debtor was in monetary default under the lease, the lease provided for an acceleration of all amounts due upon such a default and the lease and the letter of credit permitted draws to cure monetary defaults, including the accelerated damages.

⁵ While not discussed in the Fifth Circuit’s decision, the *In re PPI Ent., Inc.* decision of the Third Circuit involved a circumstance in which the amount of the letter of credit was actually less than the statutory cap on damages under Section 502(b)(6). In *In re Stonebridge*, on the other hand, the letter of credit exceeded the statutory cap on the landlord’s damages under Section 502(b)(6). The landlord in the *In*

re PPI Ent., Inc. case sought to retain the letter of credit proceeds and also assert a claim in the debtor lessee’s bankruptcy case for its damages in excess of the letter of credit proceeds. The Third Circuit in *In re PPI Ent., Inc.* held that a letter of credit provided as a security deposit under a lease must be treated like a cash security deposit and any draws thereunder must be applied toward the Section 502(b)(6) cap, as opposed to allowing the landlord to retain the letter of credit proceeds and also assert a claim for its damages in excess of the letter of credit proceeds. The Fifth Circuit in *In re Stonebridge* was required to distinguish the Third Circuit’s decision in *In re PPI Ent., Inc.*, however, in order to conclude that the letter of credit in *In re Stonebridge* was not required to be treated like a cash security deposit and limited by the capped amount that would otherwise be available to the landlord under Section 502(b)(6). The amount of the letter of credit in *In re Stonebridge* obviated the need for the landlord to file a proof of claim in the debtor lessee’s bankruptcy case and enabled the Fifth Circuit to conclude that the landlord in *In re Stonebridge* did not assert a claim against the debtor lessee and thus should not be limited by Section 502(b)(6).

⁶ It is unclear from the decision whether the letter of credit bank’s recovery would have been different or somehow limited by Section 502(b)(6) absent the bank’s settlement with the debtor permitting the bank to retain its collateral. On the one hand, the reimbursement right of a letter of credit bank against a debtor lessee can be asserted as a claim of the bank against the debtor that is independent of the lease and that does not implicate Section 502(b)(6). On the other hand, it can be argued that allowing a landlord to retain proceeds of a letter of credit securing a lease in an amount exceeding the Section 502(b)(6) cap while also allowing the letter of credit bank to retain all of the debtor lessee’s collateral fully securing reimbursement of such draw in effect results in an indirect diminution of the debtor lessee’s bankruptcy estate contrary to the design of Section 502(b)(6). On this point, it may be important to note that the Fifth Circuit on appeal permitted the landlord in *In re Stonebridge* to retain proceeds of the letter of credit in an amount that exceeded the amount the landlord would otherwise recover under Section 502(b)(6) notwithstanding the earlier recovery by the letter of credit bank of its collateral in an amount that also exceeded the amount the landlord would otherwise recover under Section 502(b)(6) (although the letter of credit bank’s recovery was based on a settlement with the debtor rather than a court’s determination after adjudication).

⁷ In cases where a guaranty or collateral securing a lessee’s lease is provided by a third party, such as a shareholder, parent or affiliate of the lessee, rather than an asset posted as a security deposit by the lessee, a landlord’s right to proceed against the third party or its collateral in the event of a default or bankruptcy of the lessee should be construed as a claim directly against such third party and not as a claim against the lessee that is limited by Section 502(b)(6). It is also interesting to note that the letters of credit in cases such as *In re PPI Ent., Inc.* were standby letters of credit posted by the lessee as a security deposit under the lease. It is unclear whether a direct-pay letter of credit provided by a lessee could be distinguished from the reasoning of cases such as *In re PPI Ent., Inc.*, in which a standby letter of credit is provided as part of the security deposit under the lease and drawn on only in the event of a lessee’s default under the lease.

⁸ A beneficiary may of course object to the addition of any language in a letter of credit or other credit instrument limiting or conditioning a draw on the amount owed by the applicable account party or obligor. In many transactions, a letter of credit or other credit instrument is obtained to provide the beneficiary with timely payment and allow the beneficiary to avoid disputes concerning the amount actually owed by the account party or obligor. In other words, the letter of credit or other credit instrument often provides a mechanism for parties to “pay now and argue later.” Adding a provision to a letter of credit or other credit instrument limiting or conditioning a draw on first determining the correct amount owed by the account party or obligor could result in a delay in payment based on an objection by the account party or credit provider concerning the amount that is actually owed.

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John “Jay” Jolley	402.346.6000	Jay.Jolley@KutakRock.com
Thomas T. Roubidoux	402.346.6000	Thomas.Roubidoux@KutakRock.com
Jeffrey T. Wegner	402.346.6000	Jeffrey.Wegner@KutakRock.com
Bruce A. Wilson	402.346.6000	Bruce.Wilson@KutakRock.com

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