

Letter of Credit as a Landlord's Protection Against a Tenant's Bankruptcy: Assurance of Payment or False Sense of Security?

by

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As any lender or vendor knows, a standby letter of credit is perhaps the safest and most attractive form of credit support. The letter of credit is the gold standard for credit enhancement in commercial transactions. The solvency of the financial institution issuing the letter of credit and the “independence principle” – the recognition that the obligation of the letter of credit issuer to the beneficiary is independent of the account debtor’s obligation to the beneficiary¹ – render the standby letter of credit a most reliable source of funds. Once the conditions of drawing on the letter of credit (usually the presentation of a certification or other documents) are satisfied, the obligation of the issuer to pay the beneficiary is a primary obligation unaffected by any disputes between the beneficiary and the account debtor on the underlying contract. If the obligor on the underlying debt files a bankruptcy petition, neither the automatic stay nor the discharge of the underlying debt will affect the beneficiary’s right to draw on the letter of credit.² It is not surprising, therefore, that commercial landlords often accept, and sometimes even require, a letter of credit in lieu of a cash security deposit to ensure payment in the event of a tenant default.

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¹The independence principle has been called the “cornerstone of letter of credit law.” See Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 738 (2001); see also, e.g., *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 590 (5th Cir. 1987) (“An issuer’s obligation to the letter of credit’s beneficiary is independent from any obligation between the beneficiary and the issuer’s customer. . . . Any disputes between the beneficiary and the customer do not affect the issuer’s obligation to the beneficiary to pay under the letter of credit.”).

²See 11 U.S.C. §§ 362(a), 524(e).

Nonetheless, standby letters of credit issued for the benefit of landlords have been dragged through a complex and tortuous road in bankruptcy cases in recent years, resulting in uncertainty, confusion, and limitations on the protection that letters of credit can give a landlord. This article will discuss the decisions dealing with the rights of the parties when a landlord is the beneficiary of a standby letter of credit and the tenant rejects the lease in bankruptcy. The article will also suggest the proper analysis and make recommendations for dealing with standby letters of credit and landlords' claims in a manner that restores the letter of credit as an effective assurance of full payment when a tenant rejects a lease in bankruptcy.

I. BACKGROUND: LANDLORDS' CLAIMS IN BANKRUPTCY

When a commercial tenant files a bankruptcy petition, the tenant has the right to reject the unexpired lease under section 365 of the Bankruptcy Code.³ Although the rejection occurs after the bankruptcy petition has been filed, the Bankruptcy Code creates the legal fiction that rejection constitutes a breach of the lease by the debtor-tenant immediately before the commencement of the bankruptcy case.⁴ Treating rejection as a prepetition breach gives the landlord's claim for damages the status of a prebankruptcy claim that, to the extent it is unsecured, may receive a distribution from the bankruptcy estate worth only a fraction of the landlord's damage claim.

The Bankruptcy Code also imposes a cap on the allowance of a landlord's damage claim. If the rejected lease is a long-term obligation, the landlord could have a large damage claim, making it less likely that other unsecured creditors will receive a meaningful distribution in the bankruptcy case. In 1934, concerned that landlords would receive a disproportionately large distribution in bankruptcy cases at the expense of other creditors, Congress amended the Bankruptcy Act of 1898 to limit the amount of landlords' claims asserted against a bankruptcy estate.⁵ The Act was repealed in 1978 and

³11 U.S.C. § 365(a).

⁴11 U.S.C. § 365(g)(1).

⁵Section 63a(9) of the Act, 11 U.S.C. § 103a(9) (1976), provided that a landlord's claim for damages resulting from rejection of a lease "shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of surrender of the premises to the landlord or the date of reentry by the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued, without acceleration, up to such date."

Concerns regarding the allowance of landlord's claims for future rent arising after rejection of a lease were raised by William O. Douglas, then a professor at Yale Law School, and Jerome Frank in an article that led to the 1934 legislation imposing a cap on landlord's claims in bankruptcy. See William O. Douglas & Jerome Frank, *Landlords' Claims in Reorganizations*, 42 YALE L.J. 1003 (1933). The authors expressed doubt as to whether "all future rent under an acceleration clause would be allowed in bankruptcy or receivership" because such allowance "would violate the spirit of the bankruptcy act and of receivership." *Id.* at 1046. "To allow such claims would in some cases practically amount to exclusion of other creditors." *Id.* at 1046 n.127.

replaced by the Bankruptcy Code.⁶ A similar limit is now found in section 502(b)(6) of the Bankruptcy Code, which provides that a lessor's claim for damages resulting from the termination of a real property lease may not be allowed to the extent that the claim exceeds the rent reserved by the lease, without acceleration, for the greater of one year, or fifteen percent not to exceed three years, of the remaining term of the lease following the earlier of the date of the filing of the bankruptcy petition or the date on which the property was repossessed or surrendered, plus any unpaid rent due without acceleration on the earlier of such dates.⁷ It is important to emphasize that this cap only limits the allowance of damage claims based on the loss of rent; the allowable claim can be no more than the landlord's actual damages.⁸

Landlords typically require a cash security deposit to secure the tenant's obligations under a lease. To illustrate how a cash security deposit may affect the allowance of a landlord's claim, suppose that a landlord holding a \$100,000 cash security deposit would be entitled under state law to \$500,000 in actual damages for the tenant's breach of a long-term lease. Also suppose that if the tenant files a bankruptcy petition and rejects the lease, the cap on the landlord's allowable claim imposed by section 502(b)(6) is \$300,000. What effect would the security deposit have on the allowance of the landlord's claim? May the landlord apply the security deposit to the actual damage claim, leaving an actual damage claim of \$400,000 and an allowable claim of \$300,000 under section 502(b)(6)? If so, the landlord could keep the \$100,000 security deposit and share in the bankruptcy estate as the holder of an allowed \$300,000 unsecured claim. Or would the security deposit be applied to the \$300,000 allowable claim, leaving the landlord with an allowed unsecured claim of only \$200,000?

In 1944, the Second Circuit resolved this issue under the former Bankruptcy Act in the oft-cited case of *Oldden v. Tonto Realty Corp.*⁹ In *Oldden*, the court of appeals held that if the security deposit is less than the amount of the landlord's allowable claim as capped by the statutory formula, the claim is treated as a secured claim to the extent of the security deposit and as an unsecured claim for the remainder of the capped claim. The theory under-

⁶The Bankruptcy Code was enacted by Title I of the Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 (1978).

⁷11 U.S.C. § 502(b)(6).

⁸Actual damages will be determined under applicable nonbankruptcy law. See, e.g., *Unsecured Creditors' Comm. of Highland Superstores, Inc. v. Strobeck Real Estate, Inc. (In re Highland Superstores, Inc.)*, 154 F.3d 573, 579 (6th Cir. 1998) (holding that lessor's damages are computed in accordance with the terms of the lease and applicable state law and then are limited by section 502(b)(6)). In this regard, a landlord's mitigation of damages may be relevant in determining the landlord's actual damage claim. See, e.g., *In re Atlantic Container Corp.*, 133 B.R. 980, 990 (Bankr. N.D. Ill. 1991) (holding that rent received by reletting the premises after rejection mitigates the landlord's actual lease termination damages).

⁹*Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944).

lying this decision is that the landlord should not receive, and the bankruptcy estate should not be liable for, more than the capped claim, regardless of whether the claim against the estate is secured or unsecured.¹⁰ If this principle is applied to the above illustration, the landlord would have a secured claim for \$100,000 and an allowable unsecured claim of \$200,000. The security deposit would reduce the allowed (capped) claim, not merely the actual damage claim. In dictum, the *Oldden* court also indicated that if the security deposit exceeds the allowed claim as capped under the Bankruptcy Act, the landlord must return the excess to the bankruptcy estate.¹¹ The legislative history of the Bankruptcy Reform Act of 1978 clearly indicates that the Code did not overrule *Oldden*,¹² and the courts have continued to follow *Oldden* in cases under the Bankruptcy Code.¹³

If a cash security deposit assures the landlord of full payment of its damage claim to the extent of the value of the security deposit, but only up to the amount of the allowable claim as capped under section 502(b)(6), how can a landlord protect itself from the imposition of the statutory cap on the allowance of its claim?

One form of credit enhancement that enables a landlord to recover actual damages above the section 502(b)(6) cap and avoids the effect of *Oldden* is the third-party guarantee. If a tenant rejects a lease in bankruptcy, nothing in the Bankruptcy Code prohibits the landlord from proceeding against the guarantor for the full amount of actual damages, so long as the guarantor is not a debtor in bankruptcy.¹⁴ The ceiling on the allowance of claims in section 502(b)(6) applies only to the assertion of a claim against the bankruptcy

¹⁰If we are correct that the statute sets a limit on damages for breach of a lease by bankruptcy, then the landlord should be entitled only to that sum and not more; otherwise the security would be in the nature of a forfeiture in the event of bankruptcy, and forfeitures are not favored by the courts." *Id.* at 921.

¹¹"The statute now makes the termination of the lease complete, and the damages fixed; and anything in excess should go to the trustee for the general creditors." *Id.*

¹²The legislative history states that a landlord "will not be permitted to offset his actual damages against the security deposit and then claim the balance under [section 502(b)(6)]. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph." S. Rep. 95-989, at 63-64, reprinted in 1978 U.S.C.C.A.N. 5787, 5849-50; H. Rep. 95-595, at 354, reprinted in 1978 U.S.C.C.A.N. 5693, 6310.

¹³*See, e.g.,* Solow v. PPI Enters. (U.S.), Inc. (*In re* PPI Enters. (U.S.), Inc.), 324 F.3d 197, 208-09 (3d Cir. 2003); Atlantic Container, 133 B.R. at 988.

¹⁴*See, e.g.,* Kopolow v. P.M. Holding Corp. (*In re* Modern Textile, Inc.), 900 F.2d 1184, 1191 (8th Cir. 1990); Things Remembered, Inc. v. BGTV, Inc., 151 B.R. 827, 831 (Bankr. N.D. Ohio 1993). If the guarantor is in bankruptcy, allowance of the landlord's claim against the guarantor's bankruptcy estate would be subject to the cap in section 502(b)(6). *See, e.g., In re* Arden, 176 F.3d 1226, 1229 (9th Cir. 1999) ("A plain reading of [section 502(b)(6)] underscores that it is the claim of the lessor, not the status of the lessee - or its agent or guarantor - that triggers application of the Cap."); *In re* McSheridan, 184 B.R. 91, 96 (B.A.P. 9th Cir. 1995), overruled on other grounds by Saddleback Valley Cmty. Church v. El Toro Materials Co. (*In re* El Toro Materials Co.), 504 F.3d 978, 981-82 (9th Cir. 2007); Hippodrome Bldg. Co. v. Irving Trust Co. (*In re* Radio-Keith-Orpheum Corp.), 91 F.2d 753, 756 (2d Cir. 1937).

estate and is not a bar to greater recovery from other sources. The guarantor is not protected by the automatic stay under section 362 of the Bankruptcy Code and does not receive the benefit of any discharge granted to the debtor-tenant.¹⁵ In addition to a security deposit or other collateral from the tenant, it is beneficial for the landlord to obtain a third-party guarantee from a solvent entity. Not only will there be another source of recovery if the landlord recovers less than the full amount of its allowed (capped) unsecured claim from the debtor-tenant's insolvent estate, but a guarantee will enable the landlord to recover actual damages without regard to the cap under section 502(b)(6).

When a landlord recovers on a guarantee, the guarantor ordinarily has certain reimbursement or subrogation rights against the tenant and therefore against the debtor-tenant's bankruptcy estate. To protect the bankruptcy estate, the Bankruptcy Code limits the rights of guarantors to reimbursement and subrogation, whether or not those rights are secured by collateral owned by the debtor. In particular, a guarantor's right of reimbursement must be disallowed to the extent that the landlord's claim against the estate is disallowed.¹⁶ The guarantor's reimbursement claim must also be disallowed if the right of reimbursement is still contingent when the bankruptcy court considers allowance or disallowance of the reimbursement claim,¹⁷ or if the guarantor asserts a right of subrogation.¹⁸ Because reimbursement on the claim must be disallowed to the extent that the landlord's claim against the estate is disallowed, a lease guarantor's reimbursement claim may not be allowed for more than the section 502(b)(6) cap. Similarly, if the guarantor pays the landlord and asserts a right of subrogation against the bankruptcy estate rather than a right of reimbursement, at best the guarantor would stand in the shoes of the landlord and be subject to the same section 502(b)(6) cap on the allowance of its claim.¹⁹ The Bankruptcy Code also subordinates the guarantor's reimbursement claim and subrogation rights to the landlord's allowed claim against the bankruptcy estate until the landlord's claim is paid in full.²⁰

However, these limitations on the guarantor's reimbursement and subrogation rights do not adversely affect the landlord's right to recover its full (uncapped) amount of damages from the guarantor in the first instance, and therefore a guarantee is an effective way for a landlord to recover an amount that exceeds the allowed claim under section 502(b)(6). It seems counter-

¹⁵See 11 U.S.C. § 524(e) (providing that "discharge of a debt of the debtor does not affect the liability of any other entity on, or property of any other entity for, such debt").

¹⁶11 U.S.C. § 502(e)(1)(A).

¹⁷11 U.S.C. § 502(e)(1)(B).

¹⁸11 U.S.C. § 502(e)(1)(C).

¹⁹See 11 U.S.C. § 509 on subrogation rights of entities that are liable with the debtor on a claim.

²⁰11 U.S.C. § 509(c).

intuitive, but a third-party guarantee from a solvent entity may be more beneficial to the landlord than a cash security deposit because the cash security deposit reduces the landlord's allowed claim in bankruptcy under the doctrine of *Oldden v. Tonto Realty Corp.* and must be turned over to the bankruptcy estate to the extent that it exceeds the capped allowed claim.

Though beneficial, a third-party guarantee of a tenant's obligations under a lease may not be easy to obtain. The guarantor also may be, or may become, financially weak and a candidate for bankruptcy itself. Even when guarantors are solvent, it is not always easy to collect from them, and costly, time-consuming litigation may be required. In rare chapter 11 cases, bankruptcy courts have enjoined enforcement of a guarantee against a key insider of the debtor when enforcement would jeopardize the success of the reorganization.²¹ A superior device, one that eliminates the risk of guarantor insolvency, enforcement litigation, and injunction against enforcement, is the standby letter of credit.

A. LETTERS OF CREDIT AS SECURITY DEPOSITS: THE THIRD CIRCUIT'S DECISION IN *PPI ENTERPRISES*

The Third Circuit was the first court of appeals to address the effects of a landlord's draw down on a letter of credit on the section 502(b)(6) cap on the allowance of landlord's claims. In *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*,²² a landlord leased office space to PPI in 1989 for use as its corporate headquarters for a ten-year period. The annual rent, payable in monthly installments, was \$620,000 for the first five years and \$650,000 for the next five years. PPI's indirect corporate parent guaranteed the lease obligations but became the subject of its own British insolvency proceeding only one year later. Sanwa Bank issued a standby letter of credit to the landlord on behalf of PPI in the amount of \$650,000. PPI stopped paying rent and abandoned the premises in 1991, at which time the remaining rent due under the lease, including future rent, totaled \$5.86 million. The landlord drew on the letter of credit, applying it in lieu of monthly rent payments until the letter of credit had been exhausted. The landlord and PPI remained in litigation for more than four years over the amount of damages resulting from the breach of the lease. On the eve of trial in 1996, PPI filed a chapter 11 petition, and the landlord filed a proof of claim in the bankruptcy case for approximately \$4.7 million in damages. This damage claim reflected the fact that the landlord had re-let a portion of the premises, thus mitigating

²¹See, e.g., *Venzke Steel Corp. v. LLA, Inc. (In re Venzke Steel Corp.)*, 142 B.R. 183, 184-85 (Bankr. N.D. Ohio 1992); *Steven P. Nelson, D.C., P.A. v. General Elec. Capital Corp. (In re Steven P. Nelson, D.C., P.A.)*, 140 B.R. 814, 816-17 (Bankr. M.D. Fla. 1992); *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 21 B.R. 777, 778-80 (Bankr. D.N.M.), *aff'd*, 25 B.R. 1018 (D.N.M. 1982).

²²*Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003).

actual damages, and the fact that the landlord received \$650,000 under the Sanwa Bank letter of credit.

The landlord took the position that, after applying section 502(b)(6), its claim was approximately \$863,000. The landlord argued that the proceeds of the letter of credit reduced the actual damages to \$4.7 million but did not reduce the amount of its allowed claim. PPI took the position that the landlord's allowed claim, as capped by section 502(b)(6), could not exceed approximately \$100,600, arguing that the amount received from Sanwa Bank under the letter of credit had to be deducted from the capped claim. Without analyzing the difference between a cash security deposit paid by a tenant and the proceeds of a letter of credit paid by an issuer bank, the bankruptcy court agreed with the PPI, equating the letter of credit with a security deposit and applying the doctrine of *Oldden v. Tonto Realty Corp.*²³ "[B]ecause Solow drew down the letter of credit for \$650,000 subsequent to termination of the lease, Solow's § 502(b)(6) claim should be reduced by that amount."²⁴

The court of appeals affirmed this treatment of the letter of credit as a security deposit. The court noted the difference between *Oldden*, which involved a security deposit given directly by the debtor-tenant to the landlord, and PPI's case, which involved a letter of credit issued by a third party, and proceeded to "consider whether this factor requires different treatment under § 502(b)(6)."²⁵ The court then summarized the arguments for not reducing the cap by the letter of credit proceeds. First, the funds received by the landlord did not come from PPI but were from another source, and the cap under section 502(b)(6) should not be reduced when funds do not come from the debtor's estate. Whether the funds come from a new tenant in the form of mitigation or from a letter of credit is immaterial to the analysis so long as the funds do not come from the debtor. Second, the court recognized the "independence principle" to separate proceeds of the letter of credit from the debtor's estate.

PPI contended that, if the \$650,000 proceeds of the letter of credit did not reduce the section 502(b)(6) cap on the landlord's allowed claim, the issuer would pursue recovery of a \$650,000 reimbursement claim from the estate. The court observed that "[i]n effect, this result would be an end run around § 502(b)(6), since [the landlord] would receive a windfall at [PPI's], and other creditors', expense, and [PPI] would be liable twice for the same amount of money."²⁶

²³*Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944).

²⁴*In re PPI Enters. (U.S.), Inc.*, 228 B.R. 339, 350 (Bankr. D. Del. 1998).

²⁵*PPI Enters.*, 324 F.3d at 208-09.

²⁶*Id.* at 209.

The court noted the tension between the purposes of chapter 11 of the Bankruptcy Code, which is “intended to permit the debtor to rehabilitate itself while simultaneously protecting creditors. The parties here posit competing legal and equitable arguments that reflect the dual purposes of bankruptcy.”²⁷ That said, the court indicated that it would rule in favor of PPI, the debtor-tenant, and against the landlord. In particular, the court wrote that “we are not inclined to disturb the rationale followed since *Oldden*”²⁸ and then quoted *Oldden* out of context:

Although the instant case is admittedly different in that the tenant here pledged his own property to cover the possibility of default, and the rights of a third party are in no way involved, yet in both situations there is an attempt on the part of the landlord to insure performance by the tenant. The difference is purely technical [I]n one case the insurance is security put up by the tenant himself, while in the other it is the credit standing of a third party procured by the tenant; this difference is insufficient to justify divergent rules as to the respective allowable claims. If the total damages are limited in the one instance, they should likewise be limited in the other instance.²⁹

This passage standing alone appears to support PPI's argument that a cash security deposit and a letter of credit should be treated the same with respect to allowance of a landlord's claim. A careful reading of *Oldden*, however, makes it clear that the Second Circuit was referring to the situation in which a guarantor of a lease was itself in bankruptcy and the landlord was asserting a claim against the guarantor's bankruptcy estate.³⁰ In that situation, the limitation on the allowance of a landlord's claim applies to a claim asserted against a guarantor or surety in bankruptcy. Clearly, the *Oldden* court was not referring to a case like *PPI Enterprises*, where a landlord that received partial recovery from a solvent letter of credit issuer was asserting a claim against the tenant's bankruptcy estate.

After setting the stage for a decision on whether, as a matter of law, proceeds from a letter of credit reduce a landlord's allowable claim under

²⁷*Id.*

²⁸*Id.*

²⁹*Id.* at 209-10 (quoting *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 921 (2d Cir. 1944)).

³⁰The *Oldden* court made the quoted statement in the same paragraph in which it discussed *Hippodrome Bldg. Co. v. Irving Trust Co. (In re Radio-Keith-Orpheum Corp.)*, 91 F.2d 753 (2d Cir. 1937), and *In re Schulte Retail Stores Corp.*, 105 F.2d 986 (2d Cir. 1939), decisions which involved a guarantor and a surety, respectively, in bankruptcy and the issue was whether a landlord's claim against the bankruptcy estate was subject to the same limitations that would apply if the landlord was asserting the claim against the tenant in bankruptcy.

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section 502(b)(6), not merely the landlord's actual damages, the court in *PPI Enterprises* took a surprising turn, writing: "[W]e need not decide the underlying question because it is clear the parties intended the letter of credit to operate as a security deposit."³¹ The court pointed to a lease provision requiring the tenant to give the landlord a security deposit in the amount of \$650,000 and quoted from a rider to the lease that provided in part:

In lieu of the cash security provided for in Article 33A, Tenant may deliver to landlord, as security pursuant to Article 33A, an irrevocable, clean, commercial letter of credit in the amount of \$650,000 issued by a bank . . . , which shall permit Landlord (a) to draw thereon up to the full amount of the credit evidenced thereby in the event of any default by Tenant . . . or (b) to draw the full amount thereof to be held as cash security pursuant to Article 33A hereof if for any reason the Letter is not renewed. . . ."³²

The rider also required that if the landlord used or applied the cash security deposit or drew down on the letter of credit, the tenant, upon the landlord's demand, had to deposit with the landlord an amount of cash or a letter of credit necessary to restore the level of the \$650,000 security deposit. Without explanation, the court found that this provision, especially the statement that the letter of credit was "in lieu of" the tenant's cash security obligation, demonstrated the parties' intent that "the letter of credit serve as a security deposit."³³ Based on that finding, the court affirmed the treatment of the letter of credit as a security deposit for the purpose of applying section 502(b)(6).

The reasoning of *PPI Enterprises* is puzzling. First, it appears that whether a draw down on a letter of credit reduces the allowed claim under section 502(b)(6) may depend on whether the lease provides that the letter of credit is, or is in lieu of, a security deposit. It appears that unlinking any security deposit from the letter of credit and expressly stating in the lease that the letter of credit is not intended to serve as a security deposit might increase the likelihood that the proceeds of the letter of credit will not reduce the allowability of the landlord's claim under section 502(b)(6). (If nothing else, the decision serves as a drafting lesson for landlords who request letters of credit.) However, one has to wonder whether *any* letter of credit issued as a credit enhancement in connection with the tenant's obligations under a

³¹*PPI Enters.*, 324 F.3d at 210.

³²*Id.*

³³*Id.*

lease is not, in substance if not form, merely a substitute for a cash security deposit.

Second, in a situation in which the parties' stated intent is that the letter of credit serve neither as a security deposit nor in lieu of one, *PPI Enterprises* does not answer the question whether, as a matter of law, the proceeds of the letter of credit reduce the allowability of the landlord's claim under section 502(b)(6) in the same way as a cash security deposit. However, the court's reasoning, including its reliance on the quoted passage from *Oldden v. Tonto Realty Corp.*,³⁴ seems to indicate that letter of credit proceeds would reduce the allowability of the landlord's claim under section 502(b)(6) in that situation.

Third, the court assumes that Sanwa Bank, as issuer of the letter of credit, would pursue a reimbursement or subrogation claim against the bankruptcy estate. "[T]his means that [the landlord] would keep the \$650,000 [drawn on the letter of credit] and [the debtor in possession] would be liable for that same amount to [the issuer of the letter of credit]."³⁵ But the court drew no distinction between the situation in which the tenant gives the issuer its own property to hold as security for the tenant's reimbursement obligation and the situation in which the tenant's reimbursement obligation to the issuer is either not secured at all or is secured only by a third party's property. For example, a corporate parent of a tenant might guarantee the lease obligations and provide the landlord with a letter of credit with a reimbursement right fully secured by the corporate parent's own cash account. In that situation, clearly, the issuer would be able to look to the corporate parent for reimbursement, and property of the debtor-tenant's estate would not be at risk. The court, however, painted with a broad brush, indicating that a letter of credit offered in lieu of a security deposit would be treated no differently than a cash security deposit given by the debtor-tenant, and never asking whether property of the estate would be at risk in connection with the issuer's reimbursement obligation.³⁶ Moreover, the court did not analyze whether, and to what extent, the issuer's subrogation or reimbursement claim would be allowable, or whether it would be subject to the section 502(b)(6) cap.

Finally, because the court relied on *Oldden v. Tonto Realty Corp.*, the logical extension of *PPI Enterprises* is that if a letter of credit exceeded the section 502(b)(6) cap on the landlord's claim, the landlord would have to give the excess to the bankruptcy estate. Suppose, for example, that a landlord's

³⁴See *supra* text accompanying note 29.

³⁵*PPI Enters.*, 324 F.3d at 209.

³⁶The facts given in the opinion do not indicate whether PPI pledged any of its assets to secure the reimbursement rights of the issuer of the letter of credit.

actual damages from a lease rejection are \$500,000, the capped allowed claim under section 502(b)(6) is \$300,000, and the debtor-tenant caused a bank to issue a letter of credit for the benefit of the landlord in the amount of \$500,000. Treating the letter of credit as a security deposit and applying the dictum of *Oldden*, a bankruptcy court would compel the landlord to pay \$200,000 to the bankruptcy estate because that is the amount by which the letter of credit draw exceeds the amount of the landlord's allowed claim under section 502(b)(6). The landlord would have no further claim against the estate. This result defeats the purpose of the letter of credit: to shift credit risk from the creditor to the issuing bank by creating an independent right against a solvent third-party to recover full damages caused by the tenant's breach or rejection of the lease.

B. THE NINTH CIRCUIT BANKRUPTCY APPELLATE PANEL REFINES
THE *OLDDEN* ANALYSIS TO APPLY TO LETTERS OF CREDIT

In *Redback Networks, Inc., v. Mayan Networks Corp. (In re Mayan Networks Corp.)*,³⁷ the Ninth Circuit Bankruptcy Appellate Panel faced the same question presented in *PPI Enterprises* - whether the proceeds of a letter of credit reduce the landlord's capped claim under section 502(b)(6) rather than merely mitigate the landlord's actual damage claim - and advanced the analysis beyond the Third Circuit's treatment.

In 2000, Mayan as subtenant entered into a five-year sublease with Redback as sublandlord. The sublease required a \$1 million security deposit, consisting of approximately \$351,000 of cash and an unconditional irrevocable standby letter of credit for approximately \$649,000 with Redback as beneficiary. When Silicon Valley Bank issued the letter of credit, Mayan pledged to the bank over \$650,000 in cash to secure its reimbursement obligation in the event of a draw down on the letter of credit. The sublease required the return of the security deposit after the end of the lease term. In 2001, Mayan Networks filed a chapter 11 petition and promptly rejected the sublease. In 2002, while the chapter 11 case was still pending, Redback drew down the full amount of the letter of credit. As the letter of credit required, the request for the draw down certified that Redback would either hold the funds drawn as a security deposit for Mayan or would apply the funds to Mayan's obligations under the sublease.

Redback then filed a proof of claim for lease rejection damages. Mayan, Redback, and the creditors' committee stipulated that approximately \$2.7 million was the amount of the capped claim according to the formula in section 502(b)(6), and the \$351,000 cash security deposit Redback held must be

³⁷*Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (B.A.P. 9th Cir. 2004).

credited against that sum. However, a dispute arose over whether the \$649,000 draw down on the letter of credit also had to be credited toward that sum to arrive at the allowable landlord's claim. The bankruptcy court held that the amount drawn on the letter of credit, as well as the cash security deposit, must be credited against the capped claim, leaving an allowed claim of approximately \$1.7 million. The bankruptcy appellate panel affirmed.

The appellate panel noted that the legislative history of the Bankruptcy Code specifically endorsed the holding in *Oldden v. Tonto Realty Corp.*, which requires that a security deposit be credited to the claim after it is capped under section 502(b)(6).³⁸ "The question is left as to whether the letter of credit will be treated like a security deposit for the purposes of calculating the amount of a landlord's claim under section 502(b)(6)."³⁹ The landlord argued that the draw on the letter of credit should not reduce the allowed claim because the letter of credit and its proceeds are not property of the estate under section 541 of the Bankruptcy Code, and the obligation of the letter of credit issuer is independent of the lease. Therefore, the landlord argued that it should be able to apply the proceeds from the draw on the letter of credit to reduce the actual damage claim *before* applying the section 502(b)(6) cap.

The court commented that, although neither the letter of credit nor its proceeds was property of the estate, that fact was a red herring:

There is nothing in the statute or in case law that suggests that the limitation in section 502(b)(6) applies only to amounts that are paid directly from property of the estate. Rather, the appropriate analysis looks to the impact that the draw upon the letter of credit has on property of the estate.⁴⁰

The court reasoned that the \$650,000 pledged to the bank to secure the bank's reimbursement obligation was property of the estate, and that in effect it was used to pay the landlord. It appears that the court, without explicitly saying so, merged or collapsed the two aspects of the transaction: the issuance of the letter of credit followed by the draw down and the issuer's taking of the tenant's cash collateral pledged by the debtor to secure its reimbursement obligation.

The court in *Mayan Networks* contrasted the situation before it to the situation the same court had faced in *In re Condor Systems, Inc.*⁴¹ Condor involved a draw on a letter of credit issued to secure the debtor's severance

³⁸*Id.* at 298.

³⁹*Id.* at 299.

⁴⁰*Id.*

⁴¹*In re Condor Sys., Inc.*, 296 B.R. 5 (B.A.P. 9th Cir. 2003).

obligations under an employment agreement. The agreement provided that the employee would have a severance package of \$1,400,000, payable in eight quarterly installments. Bank of America issued a \$1,400,000 letter of credit to fund the severance package, and the employee drew \$1,050,000 before the employer's bankruptcy and \$350,000 after the petition was filed. The employee had other damages from the termination of employment not covered by the letter of credit. Under section 502(b)(7) of the Bankruptcy Code, an employee's damages due to termination of employment are capped at past due compensation plus future compensation for one year.⁴² The bankruptcy court held that the amount of the draw down on the letter of credit had to be deducted from the section 502(b)(7) cap to arrive at the allowable claim.

The bankruptcy appellate panel in *Condor* reversed, holding that the letter of credit and its proceeds from a draw down do not affect the statutory cap on the allowance of the claim. A draw down will reduce the employee's actual damages, and double recovery should not be permitted, but the reduction should be from actual damages, not the capped allowed claim. The court distinguished a letter of credit from a security deposit, which is clearly property of the estate and must be deducted from the capped allowed claim.⁴³ Though the draw down triggered the issuer's reimbursement or subrogation claim against the debtor-employer, and the issuer could file that claim against the bankruptcy estate, the court noted that the issuer's claim would be capped under section 502(b)(7) so that property of the bankruptcy estate would not be subject to more than the employee's capped claim.⁴⁴ Moreover, the issuer's claim against the estate would be subordinated to the employee's claim under section 509(c) of the Bankruptcy Code until the employee's claim was paid in full.⁴⁵

The *Mayan Networks* court distinguished *Condor* because the debtor in *Condor* did not provide the letter of credit issuer with any collateral to secure its reimbursement obligation. Therefore, the debtor's draw on the letter of credit and the issuer's assertion of an unsecured reimbursement or subrogation claim against the estate had no adverse impact on the bankruptcy estate. "Thus, the relationship between the parties in *Condor* was more analogous to a third-party guarantee than to a security deposit,"⁴⁶ and courts have held

⁴²11 U.S.C. § 502(b)(7).

⁴³The court cited *In re Handy Andy Home Improvement Ctrs., Inc.*, 222 B.R. 571 (Bankr. N.D. Ill. 1998), for the proposition that "a prepetition security deposit in the hands of a lessor on a rejected lease must be applied to reduce the capped claim, with any excess turned over to the estate." *Condor*, 296 B.R. at 14.

⁴⁴See 11 U.S.C. §§ 502(e), 509(a).

⁴⁵11 U.S.C. § 509(c).

⁴⁶*Mayan Networks*, 306 B.R. at 300.

that the caps in section 502(b) on the allowance of claims do not limit the liability of a guarantor not in bankruptcy.⁴⁷ The court wrote:

In light of *Condor*, we do not follow the rationale of *PPI Enterprises* where the debtor did not pledge property of the estate to secure the letter of credit. However, the present case is distinguishable from *Condor* and the guarantee cases, because we do not have a true third party obligor who bears substantial risk. The Bank was fully protected if it had to pay on the letter of credit. Inserting the Bank between the Landlord and the Debtor did not change the true nature of this arrangement, which was to have Debtor provide a security deposit on the lease. The \$650,000 cash security to the Bank was property of the estate and the structure of this arrangement was really an attempt to circumvent *Oldden*. The logic of *Oldden* should apply.⁴⁸

The court reasoned that if a letter of credit is secured by a pledge of the debtor's property, the letter of credit is in the nature of a security deposit that must be deducted from the allowed capped claim under section 502(b)(6). Though the court did not have to go that far, the logical extension of its reasoning is that if the amount drawn on the letter of credit exceeds the amount of the capped allowed claim, the landlord must pay to the bankruptcy estate the excess, up to the value of the collateral the debtor pledged to the issuer. The net result is that the estate is not liable for more than the capped allowed claim.

In its conclusion, the court in *Mayan Networks*, though acknowledging the difficulty in fitting a letter of credit into the scheme of section 502(b)(6), echoed *PPI Enterprises* in equating the letter of credit with a security deposit for purposes of applying *Oldden* (though it limited this conclusion to situations where the issuer is secured by a pledge of the tenant's cash):

Letters of credit have yet to find a comfortable place in bankruptcy law. However, it is not necessary to distinguish the letter of credit in this case from the security deposit in *Oldden*. Here, the language of the lease described the letter of credit as security for the lease and the letter of credit was fully secured by a cash deposit. The draw upon the letter of credit had the same effect on the estate as the forfeiture of a cash security deposit, and the purposes of § 502(b)(6) will be

⁴⁷*Id.* (citing *Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.)*, 900 F.2d 1184 (8th Cir. 1990), and *Things Remembered, Inc. v. BGTV, Inc.*, 151 B.R. 827 (Bankr. N.D. Ohio 1993)).

⁴⁸*Id.*

best served if the same rule is applied. 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.⁴⁹

C. JUDGE KLEIN'S CONCURRING OPINION IN *MAYAN NETWORKS*

Bankruptcy Judge Christopher Klein wrote a concurring opinion in *Mayan Networks* demonstrating that the same result can be reached by applying provisions of the Bankruptcy Code and the Uniform Commercial Code, rather than merely concluding that section 502(b)(6) is ambiguous and relying on *Odden* and legislative history. In his concurring opinion, Judge Klein, who also wrote the decision for the bankruptcy appellate panel in *Condor Systems*, provided a more direct, unambiguous, statute-based approach based on a holistic analysis of a number of Bankruptcy Code and U.C.C. provisions. Judge Klein commented that “[s]ection 502(b)(6) appears to be ambiguous only when considered in isolation from the rest of the statutory scheme.”⁵⁰

The concurring opinion explained the reason for cautioning against placing too much reliance on *Odden*: there may be a temptation to extend mistakenly the holding in *Odden* – that a security deposit reduces the section 502(b)(6) cap on the allowance of the landlord's claim – to situations in which the security deposit is not property of the estate. If the security is not property of the estate (for example, when it is deposited by a third-party guarantor entitled to its return upon the performance of the tenant's obligations), or if the security is in the form of a letter of credit not backed by a lien on assets of the tenant, then it should not reduce the section 502(b)(6) cap.

Judge Klein enunciated an important policy affecting the rights of landlords. Citing section 524(e)'s assurance that a discharge in bankruptcy does not affect the liability of any entity other than the debtor, he correctly emphasized that the cap under section 502(b)(6) does not reduce the amount that landlords can recover from sources other than property of the estate. In essence, with respect to its liability to the landlord, a guarantor of the lease does not benefit from the tenant's bankruptcy. In that respect, a letter of credit is simply a “powerful guaranty.”⁵¹ Section 502(b)(6) limits what can be recovered from the bankruptcy estate but not what the landlord can recover from other sources. Therefore, credit enhancements in general may be valua-

⁴⁹*Id.* at 301.

⁵⁰*Id.* at 304 (Klein, J., concurring) (citing *United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988), and stating: “This is an occasion where it is important to pay attention to the Supreme Court's admonition that the meanings of discrete Bankruptcy Code provisions be assessed with ‘holistic’ analysis.”).

⁵¹*Id.* at 301.

ble to the landlord beyond the landlord's capped allowed claim if enforcement does not deprive the bankruptcy estate of property that exceeds the cap.

Judge Klein walked the reader through a series of Bankruptcy Code sections leading to the result in *Oldden*. When a tenant gives a landlord a cash security deposit that must be returned to the tenant at the end of the lease term if the tenant performs its obligations under the lease, and the tenant rejects the lease in bankruptcy, the tenant's right to the return of the security deposit becomes property of the estate under section 541(a) of the Bankruptcy Code.⁵² Once the lease is terminated, the estate has the right to turn-over of the security deposit under section 542(b),⁵³ subject to the landlord's right of setoff under section 553(a) for damages due to the tenant's nonperformance.⁵⁴ However, section 553(a)(1) does not permit setoff to the extent that the claim is disallowed.⁵⁵ That is where the cap comes in; section 502(b)(6) limits the landlord's allowed claim. According to Judge Klein, "[t]his is why the legislative history statement that the security deposit must be applied against the allowed claim is accurate."⁵⁶ It is also why any excess security deposit held by the landlord after deducting the allowed amount of the claim pursuant to the section 502(b)(6) cap must be returned to the bankruptcy estate. Judge Klein's analysis is consistent with the reasoning and result in *Oldden*, demonstrating that *Oldden* has survived the enactment of the Bankruptcy Code.

Judge Klein emphasized three principles underlying the Bankruptcy Code's treatment of security deposits held by landlords. First, "*the estate* will not in any guise be liable for more than the statutory cap."⁵⁷ Second, and a corollary to the first principle, the focus is the effect on the estate, not the creditor, so that the *Oldden* result applies only if the estate has a property interest in the security deposit. If a third party, such as a guarantor, supplied the security deposit, and the security deposit is refundable to the third party, the result would be different because the estate would have no interest in it. Third, any non-debtor entity liable to the landlord for the disallowed portion of its damage claim remains liable under applicable nonbankruptcy law. This

⁵²11 U.S.C. § 541(a).

⁵³11 U.S.C. § 542(b).

⁵⁴11 U.S.C. § 553(a).

⁵⁵11 U.S.C. § 553(a)(1).

⁵⁶*Mayan Networks*, 306 B.R. at 305 (Klein, J., concurring). Judge Klein also noted that the landlord's claim is temporarily disallowed in its entirety under section 502(d), which provides that the claim of any entity from which property is recoverable under, among other provisions, section 542, shall be disallowed until such property is turned over to the estate. "Thus, once the security deposit refund obligation is triggered by the termination of the lease, the security deposit must be refunded to the tenant's bankruptcy estate, but can be set off under § 553 to the extent there is an allowed claim (i.e., to the extent of the § 502(b)(6) cap)." *Id.*

⁵⁷*Id.* (emphasis in original).

principle is based on section 524(e) of the Bankruptcy Code, which provides that a discharge of debt under the Bankruptcy Code does not affect the liability of any entity other than the debtor on the discharged debt.⁵⁸ Thus, non-debtor guarantors on leases remain liable for the actual damages the landlord suffers when the tenant is in bankruptcy.

Judge Klein noted that, as a result of these principles and Bankruptcy Code provisions, landlords with long-term leases are encouraged to devise credit enhancements that will survive the tenant's bankruptcy. "Congress, in effect, has blessed such strategies through § 524(e), which leads parties to address bankruptcy risk by requiring creditworthy co-obligors or insisting that security deposits come from sources, and with refund obligations, that are not property of the estate."⁵⁹

The application of section 524(e) and an understanding that the liability of a guarantor to the landlord is unaffected by the bankruptcy case only begin the analysis. The next step is to examine the relationship between the guarantor and the debtor. The guarantor that pays the debtor's obligation would ordinarily have a right of reimbursement from the debtor and the alternative right to be subrogated to the rights of the landlord.⁶⁰ Sections 502(e) and 509 of the Bankruptcy Code govern these rights.⁶¹

As Judge Klein noted, under section 502(e), the court must disallow any claim for reimbursement of an entity that is liable with the debtor, or that has secured a claim of a creditor, to the extent that (i) the creditor's claim against the estate is disallowed,⁶² (ii) the creditor's claim is contingent at the time the claim is being considered for allowance,⁶³ or (iii) the creditor asserts the alternative right of subrogation.⁶⁴ In the case of a guarantee of a lease, if the reimbursement claim is no longer contingent because the guarantor paid the claim, and if the guarantor does not seek subrogation rights, the reimbursement claim may be allowed against the estate only to the extent that the landlord's claim against the estate has not been disallowed. The policy reason for this result is that the guarantor's reimbursement claim is not entitled to better status than the landlord's claim. Consistent with that policy, if the landlord obtains full payment of its claim from a guarantor, the allowance of the guarantor's reimbursement claim against the estate should be subject to the same limitation on claim allowance that would apply to the landlord's

⁵⁸11 U.S.C. § 524(e).

⁵⁹*Mayan Networks*, 306 B.R. at 307 (Klein, J., concurring).

⁶⁰*Id.*

⁶¹See 11 U.S.C. §§ 502(e), 509.

⁶²11 U.S.C. § 502(e)(1)(A).

⁶³11 U.S.C. § 502(e)(1)(B). If the contingent claim becomes fixed during the case, such as when the guarantor pays the claim, it may then be allowed as if the reimbursement claim had been fixed before the bankruptcy case was commenced. 11 U.S.C. § 502(e)(2).

⁶⁴11 U.S.C. § 502(e)(1)(C).

claim under section 502(b)(6) if the landlord had not been paid by the guarantor and had asserted its claim against the bankruptcy estate.

If the guarantor pays the landlord the amount of its claim and elects subrogation in lieu of reimbursement, the guarantor will stand in the shoes of the landlord and will be subject to the section 502(b)(6) cap. Moreover, under section 509, a guarantor that pays the debtor-tenant's obligation is not subrogated to the rights of the landlord to the extent that the claim is disallowed.⁶⁵ Thus, asserting subrogation rights rather than reimbursement rights will not enable the guarantor to recover an amount greater than the section 502(b)(6) cap on allowance of the landlord's claim.

Judge Klein's analysis leading to his conclusion that the guarantor's reimbursement and subrogation claims against the estate are limited by the section 502(b)(6) cap would apply equally when the guarantor has a security interest in property of the estate to secure the right of reimbursement and would lead to the conclusion that any excess collateral over the amount of the capped claim must be turned over to the estate. Judge Klein explained:

It is also possible that the third person guaranteeing payment may insist upon collateral from the tenant to secure his right to be reimbursed by the landlord. If the tenant did provide valuable collateral to the guarantor, and if the landlord has received from the estate full payment on the § 502(b)(6) capped claim and the balance from the guarantor, then the guarantor's reimbursement claim is disallowed under § 502(e) and any alternative subrogation claim is disallowed under § 509. Since the guarantor does not hold an allowed claim, its collateral is not supported by an allowed secured claim and must be returned to the trustee under § 542.⁶⁶

Does the analysis change if the tenant provides the landlord with a letter of credit instead of a cash security deposit or a third party guaranty? Undoubtedly, letters of credit differ from ordinary guarantees, the primary distinction being the so-called "independence principle" codified in section 5-103(d) of the Uniform Commercial Code for letters of credit:

(d) Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements be-

⁶⁵See 11 U.S.C. § 509(b)(1)(B).

⁶⁶*Mayan Networks*, 306 B.R. at 307 (Klein, J., concurring).

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tween the issuer and the applicant and between the applicant and the beneficiary.⁶⁷

Judge Klein noted that before the 1995 revisions to Article 5 of the U.C.C., some courts had found the independence principle an obstacle to the exercise of subrogation rights of a letter of credit issuer that paid the beneficiary.⁶⁸ The right of subrogation exists only if the person seeking subrogation is a secondary obligor, not a primary obligor. Because of the independence principle, when the issuer pays a beneficiary, the payment is one by a primary obligor under an independent contract between the issuer and the beneficiary, rather than a payment by a secondary obligor on the underlying obligation. But, as Judge Klein observed, this obstacle to subrogation was removed in 1995 with the revision of U.C.C. section 5-117(a):

(a) An issuer that honors a beneficiary's presentation is 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.⁶⁹

Subrogation rights would give the issuer no better rights than the landlord against the bankruptcy estate of the tenant, and therefore the claim asserted by way of subrogation would be limited to the section 502(b)(6) cap.

The more complex analysis relates to the effect, if any, that the independence principle has on the issuer's reimbursement rights rather than subrogation rights after the landlord draws on the letter of credit provided by the tenant. Clearly, the U.C.C. grants the issuer a right of reimbursement: "(i) An issuer that has honored a presentation as permitted or required by this article: (1) is entitled to be reimbursed by the applicant in immediately available funds not later than the date of its payment of funds"⁷⁰

Notwithstanding the distinction between U.C.C. section 5-117, which expressly provides that an issuer has the same subrogation rights as a secondary obligor, and section 5-108(i), which is silent on the question, Judge Klein relied on the 1995 amendment to section 5-117 to conclude that the issuer's reimbursement right must be treated the same as the reimbursement right of a secondary obligor on the lease:

⁶⁷U.C.C. § 5-103(d) (2002).

⁶⁸*Mayan Networks*, 306 B.R. at 309 (Klein, J. concurring) (citing *CCF, Inc. v. First Nat'l Bank & Trust Co. of Okmulgee (In re Slamans)*, 69 F.3d 468 (10th Cir. 1995)).

⁶⁹U.C.C. § 5-117(a) (2002).

⁷⁰U.C.C. § 5-108(i) (2002).

In view of new UCC § 5-117, there is no principled reason to treat letters of credit in bankruptcy as different than other guarantees for purposes of §§ 502(e) and 509. The former objection that letters of credit are primary, not secondary, obligations was obliterated by the adoption of UCC § 5-117(a) in the 1995 version of Article 5

While it is true that one of the three contracts entailed in a letter of credit transaction is the reimbursement contract between the applicant (person obtaining letter of credit) and the issuer providing for reimbursement of the issuer for draws by the beneficiary on the letter of credit, that reimbursement contract right is treated in bankruptcy like any other co-obligation and leaves the issuer of the letter of credit subrogated to the rights of the beneficiary against the estate. Once the allowable claim (up to the § 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.⁷¹

According to Judge Klein, moreover, if the issuer has a security interest in the debtor's property to secure the reimbursement right (a common arrangement), the issuer would have to turn over any excess collateral it is holding for the allowable reimbursement claim for the same reason that a landlord holding a security deposit must turn it over to the estate to the extent that it exceeds the section 502(b)(6) cap.⁷²

Based on this analysis of the Bankruptcy Code and Article 5 of the U.C.C., Judge Klein agreed with the majority in *Mayan Networks* that, in the particular circumstances of the case, the proceeds of the letter of credit resulting from the draw down must be applied to reduce the amount of the landlord's allowable capped claim under section 502(b)(6). Again, Judge Klein emphasized that the issuer had a pledge of cash collateral owned by the estate to secure the estate's reimbursement obligation.⁷³ According to Judge Klein's reasoning, though the landlord was deprived of the full benefit of the letter of credit, the limitation on the estate's liability under section 502(b)(6) justified the result: "The bottom line is that landlords are permitted to obtain credit enhancements that will net them more than the § 502(b)(6) cap, but only so long as the excess does not come from property of the estate."⁷⁴

⁷¹*Mayan Networks*, 306 B.R. at 310 (Klein, J., concurring).

⁷²*Id.*

⁷³*Id.* at 310.

⁷⁴*Id.* at 312-13.

D. THE NINTH CIRCUIT CONTINUES THE UNCERTAINTY IN *AB LIQUIDATING CORP.*

PPI Enterprises held that letters of credit provided in lieu of cash security deposits are treated the same as cash security deposits for the purposes of reducing the cap under section 502(b)(6). *Mayan Networks* narrowed that principle, limiting it to situations in which the issuer has a security interest in property of the tenant's bankruptcy estate. That was a step in the right direction. A year after *Mayan Networks*, however, the Ninth Circuit continued the uncertainty by leaving open the question whether *PPI Enterprises* or *Mayan Networks* is the proper analysis.

In *AMB Property, L.P. v. Official Creditors Committee for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*,⁷⁵ a five-year commercial lease required that the tenant provide a security deposit of \$1 million and allowed the tenant to do so in the form of a letter of credit. The tenant obtained the letter of credit and granted the issuer a security interest in its assets so that the issuer's reimbursement claim would be fully collateralized. When the tenant filed a bankruptcy petition and rejected the lease, the parties stipulated that actual damages caused by termination of the lease were approximately \$5 million and the capped allowed claim under section 502(b)(6) was \$2 million. The landlord filed a proof of claim for \$2 million and took the position that its \$1 million draw on the letter of credit reduced the \$5 million gross damages but did not reduce the \$2 million capped allowed claim. The creditors committee objected, arguing that the draw on the letter of credit reduced the capped claim so that the allowed claim would be \$1 million.

The court noted that section 502(b)(6) does not clarify whether a security deposit or a letter of credit in lieu of one reduces the capped claim and, as so many other courts have done, relied on *Oldden v. Tonto Realty* as the prevailing law.⁷⁶ Unlike the concurring opinion in *Mayan Networks*, where Judge Klein analyzed several other sections of the Bankruptcy Code holistically and located a clear answer in the statute, the court in *A.B. Liquidating* found the statute "ambiguous as to whether such deposits should be applied to a landlord's gross damages or its capped claim."⁷⁷

The court was unpersuaded by the landlord's argument that, assuming *Oldden* is the prevailing law with respect to security deposits, its holding should not be extended to letters of credit. The landlord argued that applying *Oldden* to letters of credit "will unnecessarily interfere with third-party rela-

⁷⁵*AMB Property, L.P. v. Official Creditors Comm. for the Estate of A.B. Liquidating Corp. (In re A.B. Liquidating Corp.)*, 416 F.3d 961 (9th Cir. 2005).

⁷⁶*Id.* at 964.

⁷⁷*Id.*

tionships, unduly penalize landlords while failing to advance the policy of the Bankruptcy Code, and generally wreak havoc on commercial leasing.”⁷⁸ The landlord also argued that, rather than apply *Odden* to all letters of credit serving as security deposits under a lease, the court should adopt Judge Klein’s reasoning in *Mayan Networks*⁷⁹ as the appropriate framework for analyzing the interplay between letters of credit and statutory caps on the allowance of claims.

Instead of taking a position on whether a letter of credit always reduces the cap on a landlord’s claim under section 502(b)(6), or whether it reduces the cap only when the issuer’s reimbursement claim is secured by property of the estate, the *AB Liquidating* court avoided the issue. Noting that the issuer’s reimbursement claim was fully collateralized by the tenant’s property as it was in *Mayan Networks*, the court concluded that

the resolution of this appeal does not require that we decide whether Judge Klein has set forth the appropriate procedure for applying letters of credit security deposits to landlords’ claims. Regardless of whether we apply *Odden*, or adopt Judge Klein’s reasoning, the result is the same Under either rationale, the proceeds of the letter of credit were properly subtracted from [the landlord’s] allowed claim.⁸⁰

Unfortunately, *AB Liquidating* fails to clarify whether the Ninth Circuit agrees with the Third Circuit’s view that all letters of credit serving as security deposits under leases must be deducted from the section 502(b)(6) cap, or with Judge Klein’s view that the cap should be reduced only to the extent that the issuer has a security interest in property of the estate.⁸¹

⁷⁸*Id.* at 965.

⁷⁹The court of appeals noted that Judge Klein’s approach also appears in the majority opinion in *In re Condor Sys., Inc.*, 296 B.R. 5 (B.A.P. 9th Cir. 2003), where the court held that a letter of credit reduces the cap on employee claims under section 502(b)(7) only if the issuer has a security interest in property of the estate to secure the debtor’s reimbursement obligation. See *A.B. Liquidating*, 416 F.3d at 965.

⁸⁰*A.B. Liquidating*, 416 F.3d at 965.

⁸¹Although the Ninth Circuit avoided the question of whether the cap is reduced only if the issuer is collateralized by property of the estate, the bankruptcy court in *In re Connectix Corp.*, 372 B.R. 488 (Bankr. N.D. Cal. 2007), appears to have construed *AB Liquidating* narrowly: “Under similar facts, both the appellate panel and the Ninth Circuit have concluded that a letter of credit was intended to be and should be treated as a security deposit because draws against the letter of credit would have an effect on property in the debtor’s estate.” *Id.* at 496 (emphasis added).

E. THE FIFTH CIRCUIT REFUSES TO TREAT SECTION 502(b)(6) AS AN AVOIDING POWER - CAN A LANDLORD ESCAPE THE CAP BY NOT FILING A PROOF OF CLAIM?

In *In re Stonebridge Technologies, Inc.*,⁸² the Fifth Circuit reminded us that section 502(b)(6) is no more than a limitation on the allowance of a landlord's claim against the estate, triggered by the filing of a proof of claim.

In *Stonebridge*, a landlord entered into a lease with a tenant under which the tenant was required to provide a security deposit, defined as "\$105,298.85 in cash and a letter of credit in the amount of \$1,430,065.74."⁸³ In addition to the required cash deposit, the tenant arranged for an irrevocable stand-by letter of credit in the required amount issued by the Bank of Oklahoma. To obtain the letter of credit, the tenant executed a note to reimburse the bank in the event of a draw on the letter of credit. The note was payable to the bank and secured by the tenant's \$1,250,000 certificate of deposit. Approximately one year later, the tenant filed a chapter 11 petition and rejected the lease, and the landlord drew down the full amount of the letter of credit.

The bank then sought relief from the automatic stay to apply the debtor's certificate of deposit to the bank's reimbursement claim. The trustee of a liquidating trust formed in the case reached a compromise with the bank that permitted the bank to apply the certificate of deposit to the reimbursement obligation in exchange for the bank's assignment to the trustee of the bank's claims against the landlord for an allegedly improper premature draw on the letter of credit. The trustee then commenced an action against the landlord for the alleged premature draw and also to recover the amount the landlord retained in excess of the cap under section 502(b)(6). In particular, the trustee alleged that, because of the cash security deposit and the draw on the letter of credit, the landlord's recovery exceeded the section 502(b)(6) cap by \$2,267, and therefore the landlord must pay that amount to the bankruptcy estate.

With respect to the trustee's claim against the landlord for drawing against the letter of credit an amount that, together with the cash security deposit, exceeded the section 502(b)(6) cap, the court noted that the landlord had not filed a proof of claim in the bankruptcy case. The court observed that the need to file a claim was obviated by the ample security deposit and letter of credit protection⁸⁴ but emphasized that section 502(b) applies only to claims asserted against the bankruptcy estate. The mere rejection of an unexpired lease under section 365 of the Bankruptcy Code does not automat-

⁸²*In re Stonebridge Tech., Inc.*, 430 F.3d 260 (5th Cir. 2005) (per curiam).

⁸³*Id.* at 264.

⁸⁴*Id.* at 269.

ically result in a claim against the estate; rather, a proof of claim must be filed. The court held that “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.”⁸⁵ Because the landlord never filed a proof of claim, the court found an inquiry into the appropriate interpretation of section 502(b)(6) unnecessary.

Despite its conclusion that section 502(b)(6) was irrelevant to the case, the *Stonebridge* court offered some insights about the effect of a letter of credit draw on the application of the cap. First, the court noted that “[i]t is well-established in this circuit that letters of credit and the proceeds therefrom are not property of the debtor’s estate.”⁸⁶ Moreover, the contractual rights and duties between the issuer of the letter of credit (the bank) and the beneficiary (the landlord) are entirely separate from the debtor’s estate. Citing the “independence principle,” the court noted that the issuer’s obligation to the beneficiary is independent of any obligation between the beneficiary and the issuer’s customer who provided the letter of credit.⁸⁷

The court also rejected several arguments the trustee made in seeking to recover the amount the landlord had received in excess of the section 502(b)(6) cap. First, because the landlord in *Stonebridge* had not filed a proof of claim, the court noted that the trustee’s reliance on *PPI Enterprises* and *Mayan Networks*, in which proofs of claim were filed, was misplaced. Second, the court rejected the argument that the letter of credit was part of the security deposit, and under section 502(b)(6) a landlord must return any excess security deposit above the statutory cap:

One problematic aspect of this argument is that it 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. This departs from the plain language of § 502(b)(6), which allows only one thing – disallowance of the filed claim to the extent that it exceeds the statutory cap. . . . When the Bankruptcy Code intends to create an avoidance power, it does so expressly in the language of the provision. *Stonebridge*’s argument draws an implicit analogy between the power of trustees to avoid certain preferential transfers for the benefit of the estate and the statutory cap imposed on the lessor’s lease-rejection damages claim under

⁸⁵*Id.* at 270.

⁸⁶*Id.* at 269 (citing *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586 (5th Cir. 1987)).

⁸⁷*Id.*

§ 502(b)(6) that simply cannot be squared with language in the Bankruptcy Code.⁸⁸

Although the holding in *Stonebridge* is limited – that section 502(b)(6) does not give the trustee a cause of action for any excess recovery that the landlord receives from a letter of credit issuer above the statutory cap on landlord's claims where a proof of claim has not been filed – the opinion goes further. Even if a proof of claim had been filed, it appears that *Stonebridge*, in dicta, rejects the use of section 502(b)(6) as an avoiding power, emphasizes that a letter of credit and its proceeds are not part of the bankruptcy estate, and supports the notion that a landlord never has to pay the estate any proceeds from a draw on a letter of credit, whether or not a proof of claim has been filed.

To the extent that *Stonebridge* renders section 502(b)(6) inapplicable unless a proof of claim is filed, the decision should not be taken to mean that a landlord can unilaterally escape the grasp of that section simply by declining to file a proof of claim. Section 501(c) of the Bankruptcy Code provides that “[i]f a creditor does not timely file a proof of such creditor's claim, the debtor or the trustee may file a proof of such claim.”⁸⁹ The Bankruptcy Rules allow the debtor or trustee to file the proof of claim on behalf of the creditor within thirty days after the expiration of the creditor's deadline for filing the claim.⁹⁰ If the claim arises from rejection of an unexpired lease, the bankruptcy court sets the time limit for filing the proof of claim, and the debtor or trustee has thirty days after that deadline to file a proof of claim if the creditor does not timely file one.⁹¹ In addition, in a chapter 11 case, a proof of claim is deemed filed if the claim is listed in the debtor's schedules unless the claim is scheduled as disputed, contingent, or unliquidated.⁹² Thus, a landlord does not have total control over whether its claim will be subject to allowance under 502(b)(6).

II. A PROPOSED ANALYSIS

An analysis of the effect of letters of credit as a credit enhancement for landlords should begin by separating the relationships of the three parties to the transaction.⁹³ Though there is no magic to the order of the analysis, the

⁸⁸*Id.* at 270 (citations and internal quotations omitted).

⁸⁹11 U.S.C. § 501(c).

⁹⁰Fed. R. Bankr. P. 3004.

⁹¹Fed. R. Bankr. P. 3002(c)(4), 3003(c)(3).

⁹²11 U.S.C. § 1111(a).

⁹³A letter of credit transaction generally involves three parties and three contracts. . . . The three contracts are the lease between the tenant and the landlord, the letter of credit between the landlord and the issuer, and the reimbursement agreement between the tenant and the issuer.” Winick, *supra* note 1, at 735.

three relationships will be examined in the following order: (1) the relationship between the landlord and the issuer; (2) the relationship between the landlord and the bankruptcy estate; and (3) the relationship between the issuer and the bankruptcy estate.

A. THE RELATIONSHIP BETWEEN THE LANDLORD AND THE ISSUER

If the landlord has a letter of credit to support its claim for damages for a tenant's nonperformance or rejection of the lease, nothing in the Bankruptcy Code or the case law prohibits the landlord from drawing on the letter of credit to the fullest extent its terms permit. In chapter 7 and chapter 11 cases, the automatic stay under section 362(a) does not protect third parties, including guarantors and other entities, regardless of whether the entity is liable with the debtor on the underlying obligation.⁹⁴ Similarly, a discharge of debts in any bankruptcy case does not affect the liability of entities other than the debtor.⁹⁵ Consistent with the independence principle, if the tenant files a bankruptcy petition and rejects the lease, the landlord may draw on a letter of credit provided by the tenant as credit enhancement. Even a temporary injunction prohibiting a draw on the letter of credit would violate the independence principle and should not be permitted.⁹⁶

B. THE RELATIONSHIP BETWEEN THE LANDLORD AND THE BANKRUPTCY ESTATE

As discussed earlier, the cap on the allowance of a landlord's claim under section 502(b)(6) only places a ceiling on the allowance of the claim. Thus, the first step in determining the allowance of a landlord's claim is to determine the actual damage claim the landlord would have under state law. For example, if a landlord's actual damage claim arising from a tenant's rejection of

⁹⁴See 11 U.S.C. § 362(a). Compare 11 U.S.C. §§ 1201(a) and 1301(a), which respectively provide for a codebtor stay in chapter 12 cases (debt adjustment for family farmers or fisherman with regular annual income) and chapter 13 cases (debt adjustment for individuals with regular income).

⁹⁵See 11 U.S.C. § 524(e).

⁹⁶See, e.g., *First Fid. Bank, N.A. v. Prime Motor Inns, Inc.* (*In re Prime Motor Inns, Inc.*), 130 B.R. 610, 613 (S.D. Fla. 1991) (holding that the bankruptcy court lacked subject matter jurisdiction to enjoin post-petition draw on letter of credit because the draw was not a transfer of the debtor's property); Official Comm. of Unsecured Creditors of Baja Boats, Inc. v. N. Life Ins. Co. (*In re Baja Boats, Inc.*), 203 B.R. 71, 74 (Bankr. N.D. Ohio 1996) (same); but see *Twist Cap, Inc. v. Se. Bank of Tampa* (*In re Twist Cap, Inc.*), 1 B.R. 284 (Bankr. M.D. Fla. 1979) (temporarily enjoining a draw on a letter of credit). *Twist Cap* was widely criticized, see Laura B. Bartell, *The Lease Cap and Letters of Credit: A Reply to Professor Dolan*, 120 BANKING L. J. 828, 831 (2003) ("*Twist Cap* was simply wrong"); John F. Dolan, *Standby Credits Do Not Protect Landlords from the Bankruptcy Code's Lease Cap*, 121 BANKING L. J. 383, 388 (2003) ("*Twist Cap* prompted howls of protest. . . . The ruling destroyed the efficacy of a commercial bank product."), and represents a decidedly minority view, see Winick, *supra* note 1, at 741 ("It is now widely accepted that the mere fact that a draw effectively converts an unsecured claim against the debtor (i.e., the claim of the beneficiary-creditor) into a secured claim against the debtor (i.e., the reimbursement claim of the issuer-creditor) is not a reason to enjoin the draw.").

a commercial lease, taking into account the landlord's duty to mitigate, would be \$1 million, the allowed claim under section 502(b)(6) could not exceed that amount.

Clearly, the draw on the letter of credit mitigates the landlord's actual damages. If the landlord with an actual damage claim draws on a letter of credit for that same amount, the landlord would have no damage claim at all in the tenant's bankruptcy estate. If actual damages arising from rejection are \$1 million, and the letter of credit is in the amount of \$600,000, the actual damage claim against the bankruptcy estate would be \$400,000. If the section 502(b)(6) cap is \$300,000, the allowed claim should be that capped amount. Nothing in the Bankruptcy Code would reduce the capped claim below \$300,000.

To that extent, the reasoning in *PPI Enterprises* is flawed. The Third Circuit based its decision to reduce the capped allowed claim by the amount of the letter of credit draw on the fact that the letter of credit was a security deposit. The court then applied the holding in *Oldden v. Tonto Realty*, which held that a security deposit reduces the capped allowed claim. The Third Circuit did not consider that a cash security deposit (like the one in *Oldden*) is property of the estate used as collateral to secure the tenant's obligation, whereas neither a letter of credit nor its proceeds is property of the estate.⁹⁷

In *Mayan Networks*, the court's reasoning was better because, unlike the *PPI Enterprises* court, the court in *Mayan Networks* considered the impact of the letter of credit on property of the estate. Judge Klein's concurring opinion was especially instructive and advanced the analysis substantially. Consistent with the majority's and Judge Klein's analysis, however, it would have been appropriate for the court to have reached a different conclusion. Instead of holding that a letter of credit draw reduces the landlord's section 502(b)(6) allowed claim because the issuer's reimbursement right is secured by property of the estate, the court could have held that the letter of credit does not reduce the statutory cap on the landlord's claim at all. Rather, it is the issuer's reimbursement claim that may be capped under section 502(b)(6), thus protecting the estate from excessive claims by landlords.

Although the letter of credit and its proceeds were found not to be property of the estate, the court in *Mayan Networks* based its decision on the fact that the draw on the letter of credit affected property of the estate indirectly because the issuer's reimbursement right against the debtor-tenant was secured by property of the estate. In essence, the court collapsed two separate aspects of the transaction – the landlord's claim against the estate and the

⁹⁷See, e.g., *In re Stonebridge Tech.*, 430 F.3d 260, 269 (5th Cir. 2005) ("It is well-established in this circuit that letters of credit and the proceeds therefrom are not property of the debtor's bankruptcy estate."); *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 589 (5th Cir. 1987).

issuer's secured claim for reimbursement from the estate – as if the landlord's claim against the bankruptcy estate were secured by collateral owned by the estate.⁹⁸ That kind of collapsing has no basis in the Bankruptcy Code.

It could be argued, however, that similar collapsing of letter of credit transactions has been recognized in cases involving preferences under section 547 of the Bankruptcy Code.⁹⁹ For example, in *American Bank of Martin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart)*,¹⁰⁰ the court held that if a collateralized letter of credit is issued during the ninety-day preference period to support a preexisting unsecured claim, the creditor-beneficiary of the letter of credit may be sued to recover the amount of the draw as a voidable preference under section 547. Although the creditor did not receive property of the debtor by drawing on the letter of credit, and although collateralizing the letter of credit did not involve a transfer of the debtor's property to the creditor-beneficiary, the court nonetheless held that the granting of the security interest to the letter of credit issuer indirectly benefited the unsecured creditor and therefore constituted a voidable preference.¹⁰¹

Cases like this, however, are easily distinguishable from, and are not analogous to, cases addressing the application of section 502(b)(6). Under section 547, a transfer “to or for the benefit of a creditor”¹⁰² may be avoided if the transfer is a preference. Under section 550(a)(1), the preferential transfer or its value may be recovered from either the transferee or “the entity for whose

⁹⁸Judge Klein in his concurring opinion seems to have agreed with this reasoning:

The simple answer is that, regardless of whether the premises regarding ownership of the letter of credit and its proceeds is true, the draw on the letter of credit triggered reimbursement of the issuer from, under the facts of this case, the Debtor's pledged funds that were property of the estate and that were the source of the “immediately available funds” to which the statutory reimbursement obligation applies.

Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks, Inc.), 306 B.R. 295, 310 (B.A.P. 9th Cir. 2004) (Klein, J., concurring). However, Judge Klein then offered the following as an alternative basis for his decision that the cap under section 502(b)(6) must be reduced by the draw on the letter of credit: “Moreover, the Landlord contractually agreed in the lease that letter of credit proceeds are part of the security deposit that must be refunded to the Debtor following faithful performance of the lease. Hence, the funds are unambiguously property of the estate and count against the § 502(b)(6) cap.” *Id.* at 310-11.

⁹⁹11 U.S.C. § 547. A preference is a transfer of the debtor's property, to or for the benefit of a creditor, on account of an antecedent debt, made while the debtor was insolvent and within ninety days (or one year if the creditor is an insider), that enabled the creditor to receive more than the creditor would have received in a chapter 7 case had the transfer not been made. Subject to certain exceptions set forth in section 547(c), preferences may be avoided by a trustee or debtor in possession. See generally 5 COLLIER ON BANKRUPTCY ¶ 547.01 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2008).

¹⁰⁰*Am. Bank of Martin County v. Leasing Serv. Corp. (In re Air Conditioning Inc. of Stuart)*, 845 F.2d 293, 296-97 (11th Cir. 1988).

¹⁰¹*Id.* at 296; accord *Compton Corp.*, 831 F.2d at 595.

¹⁰²11 U.S.C. § 547(b)(1) (emphasis added).

benefit the transfer was made.”¹⁰³ Clearly, giving the issuer of the letter of credit a security interest in the debtor’s property to secure the issuer’s reimbursement claim is a transfer for the indirect benefit of the beneficiary of the letter of credit; otherwise, the letter of credit would not have been issued to support the antecedent unsecured debt. Thus, under sections 547(b)(1) and 550(a)(1), the creditor-beneficiary of the letter of credit is liable to the bankruptcy estate for the preference made for its benefit when collateral was transferred to the issuer. In contrast, section 502(b)(6) has no language that would either reduce the allowance of a landlord’s claim or give the trustee the right to recover funds from the landlord in excess of the section 502(b)(6) cap based solely on a transfer of the security interest in the debtor’s property to the issuer for the benefit of the landlord. Therefore, when section 502(b)(6) is applied, any analogy to the collapsing of letter of credit transactions in the context of a preference claim under section 547 is unwarranted.

In the above hypothetical – where the landlord’s actual damages without considering the letter of credit were \$1 million, the landlord’s actual damages after the draw were \$400,000, and the section 502(b)(6) cap was \$300,000 – the reasoning of *PPI Enterprises* would give the landlord no allowed claim at all. Rather, the amount of the letter of credit (\$600,000) would be deducted from the capped allowed claim (\$300,000). Under *PPI Enterprises*, in fact, the landlord could be compelled to pay the bankruptcy estate \$300,000, the amount by which the letter of credit draw exceeded the section 502(b)(6) cap. Such a result would deprive the landlord of the primary benefit of the letter of credit and the independence principle: to recover full damages from the letter of credit issuer in the event of the tenant’s default.

The policy concern underlying the *Mayan Networks* decision is that if landlords could reap the full benefit of a letter of credit and, to the extent a deficiency remains after the draw, could also have a claim against the estate for the full amount of the section 502(b)(6) cap, and if at the same time the issuer could realize on collateral owned by the estate securing its reimbursement claim, landlords would have a way to circumvent the section 502(b)(6) cap to the detriment of the estate. Since the issuer would have a secured claim against the estate for reimbursement, the aggregate amount that the landlord and the issuer would receive from the estate could exceed the section 502(b)(6) cap. However, that result assumes the issuer’s claim against the estate for reimbursement would not itself be capped.

In any event, the rights of the issuer against the estate for reimbursement should not have any impact on the landlord’s claim against the estate. There is no basis under the Bankruptcy Code to limit the landlord’s claim against

¹⁰³11 U.S.C. § 550(a)(1); see generally 5 COLLIER ON BANKRUPTCY ¶ 550.02[4] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2008).

the bankruptcy estate merely because the letter of credit issuer's reimbursement claim against the bankruptcy estate is secured by property of the estate. Moreover, if the landlord's draw on the letter of credit exceeds the section 502(b)(6) cap, but does not exceed the landlord's actual damages caused by the breach, the landlord should not be required to pay anything to the bankruptcy estate.¹⁰⁴ The relationship between the landlord and the bankruptcy estate is, and should be, separate from the relationship between the issuer and the bankruptcy estate. Any adjustment of rights to protect the bankruptcy estate from claims arising out of the rejection of a lease in excess of the section 502(b)(6) cap, but not in excess of the landlord's actual damages, should be made when the issuer seeks reimbursement or subrogation against the bankruptcy estate.

Moreover, for the reasons given in *Stonebridge Technologies*, section 502(b)(6) has no effect unless and until a proof of claim is filed against the bankruptcy estate. If no proof of claim is filed, the allowance of the landlord's claim under section 502(b)(6) is irrelevant. Of course, as discussed above, the landlord's failure to file a timely proof of claim will not always render section 502(b)(6) irrelevant because the trustee or the debtor may file a proof of claim on behalf of the landlord if the landlord fails to do so,¹⁰⁵ and in a chapter 11 case the claim will be deemed filed if the debtor schedules the landlord's claim as undisputed, liquidated, and not contingent.¹⁰⁶

C. THE RELATIONSHIP BETWEEN THE LETTER OF CREDIT ISSUER AND THE BANKRUPTCY ESTATE

The relationship between the issuer and the bankruptcy estate is more problematic because the Bankruptcy Code and the U.C.C. provisions on letters of credit are less than clear regarding the issuer's right of subrogation or reimbursement against the bankruptcy estate.

¹⁰⁴See Winick, *supra* note 1, at 765 ("The landlord should not be required to pay any of those letter of credit proceeds to the tenant, except as and to the extent specified in the lease."). If the landlord's draw on the letter of credit exceeds the landlord's actual damages, the bankruptcy estate may have a cause of action against the landlord under state law to recover the excess. In that event, the estate's right to recover an amount equal to such excess would be property of the estate, would not violate the independence principle, and may be the subject of a turnover action under 11 U.S.C. § 542. See *In re Builders Transp., Inc.*, 471 F.3d 1178, 1192-93 (11th Cir. 2006) (holding that the debtor in possession was entitled to recover from the assignee of the lessor the difference between the \$1.6 million in letter of credit proceeds it received and the \$424,000 actual damages caused by the debtor's breach of the lease, and noting that "the turnover action taken by [the debtor] pursuant to § 542 was not predicated on the fact that its lessor's assignee retained funds in excess of the § 502(b)(6) damages cap . . .").

¹⁰⁵See *supra* discussion accompanying notes 89-91.

¹⁰⁶See *supra* discussion accompanying note 92.

As Judge Klein pointed out in *Mayan Networks*,¹⁰⁷ before 1995 some courts did not recognize a right of subrogation for a letter of credit issuer because a letter of credit is a primary obligation rather than a secondary obligation.¹⁰⁸ The prevailing view was that the right of subrogation applies only for the benefit of a secondary obligor liable on the debt with the primary obligor. To provide the issuer with the right of subrogation, section 5-117 of the U.C.C. was amended in 1995 to provide that the issuer has a right of subrogation “to the same extent as if the issuer were a secondary obligor of the underlying obligation.”¹⁰⁹

But does the issuer have a right of subrogation under the Bankruptcy Code? Section 509(a) provides that “an entity *that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor*” is subrogated to the rights of the creditor to the extent the creditor makes a payment.¹¹⁰ As discussed above,¹¹¹ because of the “independence principle,” it appears that a letter of credit issuer is not liable with the debtor on the underlying claim. It could also be argued that section 5-117 of the U.C.C. does not alter that analysis under the Bankruptcy Code. Section 5-117 does not render an issuer secondarily liable; to the contrary, it gives the issuer a right of subrogation “as if” it were secondarily liable.¹¹² Clearly, this provision recognizes that the issuer is primarily liable. It simply gives the primarily liable entity a right of subrogation under state law. Moreover, the issuer arguably does not “secure” the underlying obligation because the issuer does not give the landlord a security interest in the issuer’s assets. Rather, the landlord is an unsecured creditor of the issuer at the time the landlord begins to draw on the letter of credit.

However, it is not necessary to go that far in determining whether the issuer has a right of subrogation under the Bankruptcy Code. Even if there were a subrogation right, the issuer would merely stand in the landlord’s shoes after a draw down; the issuer would have no greater rights against the bankruptcy estate than the landlord. Any claim based on the issuer’s subrogation rights would be subject to the landlord’s cap under section 502(b)(6). Under section 509(c) of the Bankruptcy Code, moreover, the issuer’s subrogation rights would be subordinate to the landlord’s allowed claim until the landlord receives payment in full, up to the section 502(b)(6) cap.

¹⁰⁷*Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 308-09 (B.A.P. 9th Cir. 2004) (Klein, J., concurring).

¹⁰⁸Before 1995, courts were divided on whether a letter of credit issuer had the right of subrogation. See *CCF, Inc. v. First Nat’l Bank & Trust Co. of Okmulgee (In re Slamans)*, 69 F.3d 468, 475 n.5 (10th Cir. 1995) (listing decisions).

¹⁰⁹U.C.C. § 5-117(a) (2002).

¹¹⁰11 U.S.C. § 509(a) (emphasis added).

¹¹¹See *supra* discussion accompanying notes 67-69.

¹¹²See U.C.C. § 5-117(a).

The more difficult analysis focuses on the issuer's reimbursement claim against the bankruptcy estate. If the landlord draws on the letter of credit, the right of reimbursement gives the issuer a claim against the tenant's bankruptcy estate. The question is whether the reimbursement claim is subject to the limitations on the allowance of a landlord's claim under section 502(b)(6). As discussed above,¹¹³ section 502(e) requires disallowance of a reimbursement claim to the extent that the creditor's underlying claim against the estate is disallowed. Thus, if a letter of credit is treated the same as any other guarantee, the issuer's right of reimbursement will be limited by the section 502(b)(6) cap.

However, the landlord's cap would apply to the issuer's reimbursement claim only if section 502(e) were applicable to letters of credit. Section 502(e) applies only to a "claim for reimbursement . . . of an entity *that is liable with the debtor on or has secured the claim of a creditor. . . .*"¹¹⁴ The question is whether, in view of the independence principle, the issuer is "liable with the debtor" on the lease or "has secured" the tenant's obligations under the lease. Though the 1995 amendments to U.C.C. section 5-117 make clear that the issuer's right of *subrogation* is the same as if the issuer were a secondary obligor on the underlying obligation, the U.C.C. is silent on whether the issuer's right of *reimbursement* is the same as if the issuer were a secondary obligor. Because of the independence principle, it appears that the issuer's obligation to pay the landlord is separate from the underlying lease and the issuer is not an entity "liable with" the tenant on the lease.¹¹⁵ It could also be argued that the letter of credit does not "secure" the tenant's obligations under the lease because that term implies a security interest in property. An issuer of a letter of credit does not provide collateral or a lien on property to secure the tenant's obligations to the landlord. Rather, as between the landlord and the issuing bank, the letter of credit is an unsecured obligation of the

¹¹³See *supra* discussion accompanying note 62.

¹¹⁴11 U.S.C. § 502(e)(1) (emphasis added).

¹¹⁵See, e.g., *Hamada v. Far E. Nat'l Bank (In re Hamada)*, 291 F.3d 645, 650 (9th Cir. 2002) ("In short, issuers of letters of credit are not 'liable with' the debtor on the obligation owed to the creditor"); *Slamans*, 69 F.3d at 476 (holding that the issuer's obligation to honor a demand for payment under a standby letter of credit did not render the issuer "liable with" the debtor under the underlying distribution agreement). *But see, e.g., Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 308 (B.A.P. 9th Cir. 2004) (stating that a reimbursement right of an issuer of a letter of credit "is also honored by § 502(e) as a 'claim for reimbursement . . . of an entity that is *liable with* the debtor on the claim of a creditor'") (Klein, J., concurring) (emphasis in original); *In re Valley Vue Joint Venture*, 123 B.R. 199, 204 (Bankr. E.D. Va. 1991) ("[W]here a standby letter of credit is used to support a loan from the beneficiary to the debtor, a confirming bank, by honoring the credit and thereby reducing the debtor's obligation to the beneficiary, is 'an entity that is liable with the debtor on, . . . a claim of a creditor against the debtor'").

issuing bank.¹¹⁶ Thus, section 502(e) arguably does not apply to the issuer's reimbursement rights, and no Bankruptcy Code section has the effect of capping the allowance of the reimbursement claim to the formula in section 502(b)(6), which applies literally only to the claims of a lessor, not the reimbursement claim of a letter of credit issuer.¹¹⁷

It would be better as a matter of policy, however, to limit the issuer's right of reimbursement to the capped landlord's claim under section 502(b)(6). That would protect the bankruptcy estate by limiting both the landlord's claim and the letter of credit issuer's reimbursement claim to an aggregate amount equal to the landlord's cap. Moreover, limiting the issuer's right of reimbursement would not violate the independence principle. That principle protects the landlord's right to draw on the letter of credit; it does not protect the issuer's reimbursement rights. Nonetheless, section 502(e) appears to lead to the opposite conclusion because the independence principle and Article 5 of the U.C.C. preclude the issuer from being "liable with the debtor."¹¹⁸

One possible approach is to find that the letter of credit issuer "is an entity that . . . has secured" the underlying landlord's claim within the meaning of section 502(e).¹¹⁹ Though the Bankruptcy Code defines "security inter-

¹¹⁶See *Bank of Am. Nat'l Trust & Sav. Ass'n v. Kaiser Steel Corp.* (*In re Kaiser Steel Corp.*), 89 B.R. 150, 154 (Bankr. D. Colo. 1988) (noting that "[n]o decisions have been found directly considering the meaning of the word 'secured' in this context," and holding that the word "secures" in the context of section 509 of the Code means that property is pledged as collateral for another's debt without any personal obligation). The *Kaiser Steel* court rejected the argument that "it means something more than pledging property to 'secure' someone else's debt and should be given a broad, general dictionary meaning." *Id.*; see also *Beach v. First Union Nat'l Bank of N.C.* (*In re Carley Capital Group*), 119 B.R. 646, 648 (W.D. Wis. 1990) ("[A] sequence of contracts leading to the issuance of a letter of credit in favor of a lender does not establish that the customer who arranged for the letter of credit has 'secured the debt' . . . [A] letter of credit is an independent and primary obligation of the issuer to the beneficiary and is not the 'pledge' of any asset."); *Valley Vue*, 123 B.R. at 204 n.10 ("Even though in general discourse it is commonly said that a standby credit 'secures' a loan, such term, as used in Section 509(a), refers to the granting of a security interest in an asset."). Note that even if the issuer takes a security interest in the tenant's assets to secure the issuer's reimbursement rights against the tenant in the event of a draw down, that differs from the grant of a security interest in the issuer's assets to "secure" the tenant's obligations to the landlord under the lease.

¹¹⁷See *Bartell*, *supra* note 96 at 832-33 (Where the issuer asserts its reimbursement right rather than its subrogation right, "the issuer sues in its own behalf; Section 502(b)(6) limits only claims of lessors, not other parties. To limit the reimbursement claim of a letter of credit issuer is not justified by the language of the statute.").

¹¹⁸11 U.S.C. § 502(e)(1).

¹¹⁹11 U.S.C. § 502(e). Although many courts have analyzed the question of whether a letter of credit issuer is "liable with the debtor" on a creditor's claim within the meaning of sections 502(e) or 509, fewer courts have analyzed the question of whether the issuer has "secured" the claim of the creditor. See *Kaiser Steel*, 89 B.R. at 154 (citing section 509 and noting that "[n]o decisions have been found directly considering the meaning of the word 'secured' in this context"); see also *Slamans*, 69 F.3d at 473 n.4 (holding that a letter of credit issuer was not "liable with the debtor" under section 509 but noting that the issuer did not contend that it had "secured" the underlying claim of the creditor); *In re Agrownautics, Inc.*, 125 B.R. 350,

est”¹²⁰ and speaks of a “secured claim”¹²¹ it does not define “secured.” *Black’s Law Dictionary* defines “secured” as “supported or backed by security or collateral,”¹²² giving the impression that something other than collateral could render a claim “secured.” It also defines “security” as, among other things, “[a] person who is bound by some type of guaranty.”¹²³ It could be argued that a letter of credit “secures” an underlying obligation, even though the letter of credit gives rise to a separate and primary obligation and does not involve a security interest in the issuer’s property. This broad reading of “secured” would be consistent with *PPI Enterprises*, where the court treated a letter of credit as a security deposit without questioning whether the letter of credit involved a lien on the debtor’s property.¹²⁴ This reading would also be consistent with Judge Klein’s concurring opinion in *Mayan Networks*, where he found that the issuer’s reimbursement right was “secured” by the letter of credit for purposes of limiting the issuer’s claim under section 502(e).¹²⁵

In any event, the uncertainty about whether an issuer’s claim against the bankruptcy estate for reimbursement is subject to the section 502(b)(6) cap, so as to protect the estate from paying more than the landlord’s capped allowed claim, should have no impact on the allowability of the landlord’s claim against the estate. The landlord’s relationship with the debtor is separate from the issuer’s right to pursue a reimbursement claim against the bankruptcy estate.

To avoid uncertainty, Congress should amend section 502(e) to provide expressly that it applies to letters of credit. In particular, that subsection should be amended to state that “the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, or that is liable on a letter of credit issued to support the claim of a creditor, to the extent that – (A) such creditor’s claim against the estate is disallowed” That amendment would cap the issuer’s reimbursement claim against the estate to the same extent that section

353 (Bankr. D. Conn. 1991) (concluding without discussion or citation that letter of credit issuers are not “parties that have secured a creditor’s claim”).

¹²⁰11 U.S.C. § 101(51).

¹²¹11 U.S.C. § 506(a)-(d).

¹²²BLACK’S LAW DICTIONARY 1384 (8th ed. 2004).

¹²³*Id.*

¹²⁴*Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003).

¹²⁵*Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 308 (B.A.P. 9th Cir. 2004) (Klein, J., concurring) (“Such a reimbursement right, statutory or contractual, is honored in bankruptcy by § 502(e) as a ‘claim for reimbursement . . . of an entity that . . . has secured the claim of a creditor,’ which is allowed subject to section 502(e)’s stated limits.”); see *supra* discussion accompanying note 116.

502(b)(6) caps a landlord's claim, while giving landlords the full benefit of letters of credit.¹²⁶

A predictable response to this suggestion, and to the analysis in this article, is that if a letter of credit issuer has only a limited reimbursement right against the estate, the issuer will not be willing to provide an unconditional letter of credit to support a tenant's obligations under a lease. Issuers ordinarily do not assume credit risks with respect to reimbursement obligations, which is why they often insist on fully collateralizing the borrower's reimbursement obligation. It is possible that if a landlord can draw down on the letter of credit and keep the proceeds notwithstanding the cap under section 502(b)(6), but the issuer's reimbursement claim is capped under section 502(b)(6) with the risk that the issuer may have to return a portion of its collateral, issuers will either refuse to issue letters of credit for the benefit of landlords, raise their fees to account for the risk,¹²⁷ or limit the letter of credit to the capped claim under section 502(b)(6) so that the landlord has no right to draw an amount that exceeds the cap. Whatever approach issuers take, the contract executed when the lease commences will determine the extent to which the landlord's risk of a tenant's bankruptcy will be shifted to a bank by way of a letter of credit. That way, landlords and letter of credit issuers at least will know what to expect and will know the degree of risk they have in the event of the tenant's bankruptcy. They will have the freedom to alter or allocate such risk among themselves contractually, while bankruptcy estates are protected under section 502(b)(6) from excessive claims arising out of the rejection of leases.

III. CONCLUSION

Despite several appellate decisions in the past five years on the impact of a landlord's draw on a standby letter of credit, there is still uncertainty as to whether the draw reduces the amount of the landlord's allowable claim under section 502(b)(6), or whether a trustee or debtor in possession may recover from the landlord the amount of the draw to the extent that it exceeds the capped claim. There is also uncertainty as to whether sections 502(b)(6) and 502(e), read together, limit the issuer's right to reimbursement from the bank-

¹²⁶It is worth noting that the "independence principle" underlying the law of letters of credit would not be compromised or affected by limiting the reimbursement claim of the issuer. The independence principle embodied in U.C.C. section 5-103(d) applies only with respect to the rights and obligations of an issuer to the beneficiary of the letter of credit; it does not apply to the rights of an issuer against the applicant for reimbursement.

¹²⁷See Christopher Combest, *How Secure is That Lease?*, BUS. L. TODAY Nov./Dec. 2006, at 11, 15 ("While it seems unlikely that issuers will eliminate unsecured [letters of credit], they are likely to adjust the pricing of such instruments - at least when used as security for real property leases - to reflect whatever increased risk the issuers perceive to be associated with them.").

ruptcy estate. Until a clear body of law develops on these issues, landlords relying on letters of credit to assure the recovery of actual damages from the rejection of leases in bankruptcy may be lulled into a false sense of security.

Ideally, courts will apply the Bankruptcy Code correctly to restore the integrity of the standby letter of credit. Courts should recognize that the receipt of funds from a third party does not reduce the landlord's allowable claim against the estate, and, similarly, that the statutory cap on the allowance of claims is not an avoiding power that permits a trustee to compel the landlord to turnover a portion of a letter of credit draw. Moreover, the existence of collateral securing the tenant's obligation to reimburse the issuer should have no effect on claims and rights as between the landlord and the bankruptcy estate. Though courts and commentators disagree about the impact of a letter of credit on the issuer's reimbursement rights against the bankruptcy estate, it would be preferable from a policy standpoint if any adjustment of rights designed to protect the estate from excessive liability relating to the rejection of a lease is achieved by limiting those reimbursement rights so that the issuer's claim, together with the landlord's claim, does not exceed the capped claim under section 502(b)(6). This framework will place the risk of loss caused by the tenant's bankruptcy on the issuer, where it belongs, so that a standby letter of credit can serve as a total credit enhancement, subject to any contractual limitations the parties have negotiated.
