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# LETTERS OF CREDIT AND TENANT'S BANKRUPTCY

Landlords have long used letters of credit as additional security for a tenant's performance under the lease. The letter of credit provides an independent, and often more reliable, source of collateral for tenant performance in the event of default. Under the right situation, a letter of credit is better than the traditional security deposit and even better than a guaranty. The use of the letter of credit as a source of security for the tenant's performance shifts to the financial institution the evaluation of tenant credit worthiness.

In Texas, letters of credit are governed by Chapter Five of the Texas Business and Commerce Code. The letter of credit has three parties.

1. The first party is the tenant, who is required by the lease to have the letter of credit issued.
2. The second party is the landlord, who is the beneficiary of the letter of credit.
3. The third party is the issuer (the financial institution that is obligated under the letter of credit).

## **Don't Forget the Out-of-Pocket Costs**

A letter of credit may be used in a variety of commercial transactions. In connection with the commercial lease, since no actual dollars are being delivered, a landlord may find it easier to secure a larger dollar amount for the security of the tenant's performance of the lease.

Further, a landlord should not limit



the amount of the letter of credit to rent (standard is usually one or two months), but should include out-of-pocket expenses the landlord may incur in connection with the lease (i.e., commissions and build-out costs). Obviously, the larger the letter of credit, the better the security is for the landlord.

## No Defenses for Issuer

Further, letters of credit do not afford the issuer/bank the defenses a landlord might encounter if it were demanding payment from a guarantor. Guarantors can put

ing as the basis for an event of default. This means that a tenant's bankruptcy filing cannot be the landlord's sole basis for declaring an event of default in order to exercise the landlord's remedies against the tenant. Thus, if your letter of credit is tied to the lease, you must have more than the bankruptcy filing in order to trigger the event of default. So keep the letter of credit a separate obligation like the guaranty of lease and not like the security deposit which is dependant on the lease default.

Any attempt to cash in a tenant's security deposit after a bankruptcy filing will likely be reversed by the bankruptcy court. In other words, if the landlord has not already

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forth the defense that the tenant did not have to perform under the lease, and therefore the guarantor is not liable under the guaranty. Guarantors often file counterclaims regarding these issues and run up litigation costs. If the letter of credit is drawn up correctly, an issuer of a letter of credit cannot assert such claims.

Once there is an event of default or other triggered event, a letter of credit is relatively easy to draw down. The event of default or other triggered event allowing the draw should be found in the letter of credit document itself, and not just in the lease. By having an independent letter of credit, all the landlord must do is present the letter of credit to the issuer and demand payment. No notice or other act should be required.

## Bankruptcies Are Messier

In the event of a bankruptcy, though (if the triggered event was the bankruptcy filing by the tenant), a bankruptcy court may stop or reverse the draw of the letter of credit. When a landlord receives notice of a tenant's bankruptcy, not only are all demands, notices and collections to stop, but any attempt to declare an event of default under the lease is prohibited by the automatic stay.

Further, the Bankruptcy Code invalidates an ipso facto bankruptcy fil-

applied the tenant's security deposit before the bankruptcy filing, the security deposit may be determined to be an asset of the tenant/debtor. As such, any application of the security deposit after a tenant's bankruptcy filing is subject to reversal, in which case the landlord may be obligated to reimburse the security deposit to the bankruptcy estate.

Under certain situations, the same is true with a letter of credit. Therefore, even though most landlord lease forms state that a tenant's bankruptcy filing constitutes an event of default that triggers landlord's remedies, once a tenant files for bankruptcy a landlord is limited as to what a landlord can realistically achieve.

As you can see, if the landlord has not already applied the security deposit prior to the bankruptcy filing, the security deposit will not help. If the landlord has a letter of credit the landlord will have case law support to argue that demand and presentment of the letter of credit to pay the rent damages (even after the bankruptcy filing) is a demand on the issuer, not a demand on the tenant/debtor in bankruptcy, and therefore falls outside the bankruptcy proceedings. These are good arguments that should prevail.

## Independence Is Freedom

At least one bankruptcy court has held that, if the letter of credit was tied to the lease, which requires an event of default under the lease, the bankruptcy filing stopped any collection or draw down of the letter of credit. Therefore, a landlord must carefully draft the letter of credit to be truly independent of the lease. The lease should refer to the letter of credit as an independent obligation and not as a security deposit. If the letter of credit is deemed independent of the lease, meaning not a security deposit, but rather an obligation of a third-party financial institution, bankruptcy

courts are more reluctant to prohibit

the draw on a letter of credit by the landlord after the bankruptcy filing. A bankruptcy trustee may argue that the letter of credit exceeds the cap a landlord may recover in future rents under the Bankruptcy Code or that it is money of the tenant/debtor's estate, but the argument should fail if the letter of credit is drafted correctly.



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## Summary

In conclusion, obtaining a letter of credit in connection with a lease is highly recommended. A letter of credit works as additional security for a tenant's performance under the lease and can be a more effective tool than a security deposit or guaranty. If drafted independently of the lease, should the tenant end up in bankruptcy, it provides additional protection for the landlord. Finally, enforcing the letter of credit is simple. Remember, the only act required by a landlord for payment on a letter of credit should be presentment to the issuer upon an event of default of the lease, which should be defined in the actual letter of credit document.

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*Brian D. Womac founded Womac & Associates in 1987. The firm is an aggressive commercial based law firm providing a broad range of legal services to companies and individuals on a statewide basis. The firm specializes in commercial landlord/tenant lease negotiations, real property transactions and litigation. The firm's client base consists of real estate management and brokerage companies, as well as others owning real estate. Brian D. Womac has been licensed as an attorney in Texas since 1985, and has been board certified in commercial real estate law since 1991. Brian has litigated over 2,000 landlord/tenant disputes in Texas. He can be reached via e-mail at [brianwomac@aol.com](mailto:brianwomac@aol.com) or [bwomac@brianwomac.com](mailto:bwomac@brianwomac.com).*