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## LETTERS OF CREDIT (Part III)

### Controlling a Landlord's Right to Draw on the Letter

In an earlier News ReLease, titled "Security Deposit Insecurity," we discussed the benefits to commercial landlords of letters of credit in preference to security deposits, advance rent, guarantees, and indemnity agreements. In a follow-up News ReLease, titled "The ABC's of a Letter of Credit," we elaborated on the nature of letters of credit and discussed certain features a landlord will want the letter to contain. This News ReLease completes the discussion, addressing tenants' legitimate concerns that their landlord not obtain the funds held under the letter of credit unless they are actually entitled to them under the lease.

The two main benefits that letters of credit provide to landlords over other forms of security are: (1) there is little chance the landlord will have to surrender the letter of credit proceeds to a trustee in bankruptcy in the event of the tenant's insolvency, and (2) the landlord can access the funds held under the letter of credit without bringing a claim in court to prove its damages.

These features exist because, at law, letters of credit are considered to be autonomous from the underlying transaction. In other words, the issuer of the letter of credit (most often a bank) is obligated to pay solely on the terms stipulated in the letter itself, independent of the lease or the circumstances between the landlord and tenant.

This autonomy can cause concern for tenants. If the bank is obligated to pay out on the letter irrespective of the lease, what would prevent the landlord from drawing on the letter of credit where the tenant is not in default? What would prevent the landlord from drawing for amounts in excess of the actual financial losses caused by the tenant's breach? The answer is: "Nothing - unless the letter of credit or the lease provides otherwise."

For this reason, tenants seek to curb a landlord's right to draw on a letter of credit. This may be accomplished in two complementary ways: (1) by stipulating, **in the letter** itself, a list of specific documents which the landlord must present to the issuing bank to obtain payment, and (2) by providing specific provisions **in the lease**, that regulate and clarify the landlord's entitlement to the funds available under the letter.

#### DOCUMENTARY REQUIREMENTS

In many instances, a letter of credit is simply payable "on demand." This means that all a landlord must do to obtain the funds is walk into the issuing bank with the original letter of credit and make demand, i.e. request payment. In order to reduce the likelihood of a landlord drawing on the letter without entitlement under the lease, tenants might require that there be certain documents **listed in the letter itself**, which the landlord must present to the issuing bank at the time of its demand. One useful document would be a certificate from an officer of the landlord certifying that the tenant is in default under the lease and that, accordingly, the landlord is entitled to draw on the letter of credit. While the necessity to produce such a document will not, strictly speaking, prevent a landlord from prematurely or excessively drawing on the letter, a tenant may take some comfort in knowing that the requirement to provide an officer's certificate will likely prompt the landlord to carefully assess its entitlement to the funds before marching into the bank.

#### LEASE PROVISIONS

Tenants might also limit their landlord's right to access letter of credit funds by restricting the landlord's right to draw on the letter through conditions set out in the lease. The most important condition typically included in the lease

prior to the landlord being entitled to make demand on the letter of credit is that notice of the default must have been provided to the tenant and the tenant must have failed to cure the default within the applicable cure period.

Tenants may also want to include a lease provision requiring the landlord to mitigate its damages prior to drawing on the letter. Landlords will resist this condition because if the landlord chooses not to terminate the lease, the common law holds that the landlord has no obligation to mitigate the damages it suffers as a result of the tenant's breach. Furthermore, it may take months for a landlord to effectively mitigate its loss. Landlords maintain that the burden of the tenant's default should be borne by the defaulting tenant, not the innocent landlord. A more balanced provision would provide that the landlord is entitled to draw on the letter in an amount equal to the landlord's good faith and reasonable estimate of its damages, and once the actual damages are established, the landlord is obligated to provide the tenant with an accounting.

It is important to note that requirements in the lease may not prevent the landlord from drawing on the letter prior to the conditions being satisfied. To reiterate, the letter is independent of the lease; the bank's obligation to pay the landlord depends only on the requirements listed in the letter. However, there are two benefits to the tenant in including lease provisions curbing the landlord's unilateral right to draw on the letter: (1) if the landlord does not comply

with the lease terms and improperly or prematurely draws on the letter of credit, the tenant will have a claim under the lease for repayment of the amounts improperly drawn, and (2) in a dispute scenario the lease serves as a procedural guide to the parties as to how to address the dispute. Therefore, while lease provisions imposing conditions on the landlord's right to draw on the letter don't actually prevent the landlord from obtaining the funds, they provide value as contractual obligations to be complied with. A landlord knows if it doesn't comply with the requirements in the lease, it puts itself in default and jeopardizes its right to retain the letter of credit funds.

Typically, a letter of credit clause in the lease will state that if the landlord draws on the letter of credit, the tenant must restore the letter to the original amount, failing which the landlord may (1) note the tenant in default and avail itself of all remedies under the lease, including termination, and (2) if the draw was only partial, draw on the remaining balance of the letter and hold the funds as a security deposit.

Letters of credit provide landlords with better protection than most other commonly used forms of security. However, as discussed in our three News ReLeases on this topic, when using letters of credit to secure a tenant's obligations under a commercial lease, there are many nuances to be finessed. In the right circumstances, the effort required to achieve the enhanced protection that letters of credit provide can be worthwhile.

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