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# THE ABCs OF A LETTER OF CREDIT

## WHEN USED TO SECURE TENANT OBLIGATIONS UNDER A COMMERCIAL LEASE

Landlords often require that their tenants provide some form of security to backstop their obligations under a commercial lease. While security deposits and advanced rent are commonly used, a tenant's secured creditors and/or a trustee in bankruptcy may be able to scoop these funds out of the landlord's hands. Our March 2016 *News ReLease* – "Security Deposit Insecurity" discussed potential pitfalls and suggested that landlords might prefer to rely on third party assurances, such as guarantees, indemnities and letters of credit (all of which should be able to withstand the bankruptcy of the tenant). This *News ReLease* elaborates on letters of credit. Our next *News ReLease* will address some qualifications on the landlord's right to draw on a letter of credit, including: use of the funds to remedy the breach, overcompensation concerns, mitigation of damages, restoration of the letter of credit to its original amount, and more.

In contrast to security deposits or advanced rent, third party assurances are not given by the tenant, but rather by a third party. Properly worded third party assurances secure the tenant's obligations even after disclaimer of the lease in an insolvency proceeding.

But, third party assurances are not without some weaknesses. First, like any promise, a third party assurance is only as valuable as the party giving it. If that party does not have sufficient financial wherewithal to satisfy the tenant's obligations, the security will provide little protection. Second, in the case of guarantees and indemnities, the landlord may be required to commence a court action to prove its damages resulting from the tenant's default. And, depending on the wording of a guarantee, the landlord may be required to exhaust its remedies against the tenant before pursuing the guarantor (which may entail participating in the tenant's insolvency proceedings).

Letters of credit are typically provided by third parties with sufficient assets to back up the tenant's obligations, such as a bank or other financial institution. There is no reason the letter of credit could not be provided by a non-bank entity. In general, letters of credit do not seem to suffer from the weaknesses described above. Letters of credit are often claimable without permitting the bank to make any inquiry into the underlying transaction (i.e., the lease), thereby eliminating the need for the landlord to prove its damages prior to realizing on its security.

At its most basic, a letter of credit is a written promise from an "issuer" (usually a bank) to make a payment to a "beneficiary" (in this case, a landlord) upon the presentation of documents specified in the letter of credit. (Historically, letters of credit were used for the international sale of goods. An exporting seller required the importing buyer to provide a letter of credit for the purchase price at a bank in the exporting seller's home country. This gave the exporting seller confidence that once it shipped the goods and presented the shipping documents to its local bank, payment would be made. Nowadays, letters of credit are increasingly used in domestic transactions and circumstances other than the sale of goods.) When securing a tenant's obligations under a commercial lease by way of a letter of credit, care must be taken to ensure the letter of credit contains the following attributes:

**Irrevocable & standby:** A letter of credit securing a tenant's lease obligations should be an "irrevocable, standby" letter of credit. Irrevocability means that the issuer cannot revoke or amend the letter without the landlord's consent. Standby means that the letter is being used as security for performance of an underlying transaction (i.e., the lease). The letter of credit should plainly state that upon the landlord's presentation of a written statement of the tenant's default under the lease, the issuer will pay the amount demanded to the landlord without inquiring as to the circumstances of the default or whether the landlord has the right to make such a demand. Payment by the issuer should not be conditional on any subjective test, nor should it give the issuer the option to deny payment once the landlord has submitted the appropriate statement. Lease provisions establishing conditions or restrictions on a landlord's right to draw on the letter of credit will be discussed further in the next *News ReLease.*

**Issuer:** A landlord will want to ensure that the issuer has the financial capacity to pay upon demand. Typically, a landlord will require that the letter of credit be issued by a reputable bank or financial institution (optimally a Schedule I Canadian Chartered Bank). Since drawing on the letter of credit requires presentation of the original letter, a landlord would be wise to ensure that the

bank branch designated for honouring the credit is close to the landlord's office.

**Expiry:** Letters of credit always come with an expiry date, after which the issuer is no longer required to pay. The lease must stipulate that the letter of credit will not expire before the end of the lease term, or if it does, that it will be **automatically renewed** throughout the term. Most banks will only issue letters of credit with a term of one year. In this case, the lease should obligate the tenant to replace the letter of credit annually and furthermore stipulate that the tenant's failure to do so is a default under the lease entitling the landlord to all of its remedies under the lease as well as the right to draw on the letter of credit despite the lack of any other default, and hold the funds as a security deposit until the tenant delivers a fresh/replacement letter of credit.

**Transferable:** Unless the contrary is stated in the letter, the issuer has no obligation to make payment to any party other than the named beneficiary. If a landlord wishes to assign the letter of credit to a purchaser, the letter of credit must expressly permit such a transfer.

**Surviving bankruptcy:** One of the chief benefits of using a letter of credit is that it is believed to withstand disclaimer of the lease in an insolvency proceeding. However, it is wise to include an express provision in the letter to this effect. The lease should make clear that the letter of credit is intended to secure the tenant's failure to perform its obligations under the lease, including all amounts that would have been payable by the tenant over the unexpired balance of the term had the lease not been disclaimed, cancelled, or otherwise brought to an end pursuant to insolvency legislation.

Additional features might include the landlord's ability to make partial draws and require replenishment by the tenant. A tenant will want to specify the documentation the landlord must present in order to obtain payment (such as a sworn statement by a director of the landlord entity).

It must be acknowledged that letters of credit are not a panacea. Administering the renewal of annually expiring letters, dealing with the reluctance of issuing banks to honour a letter of credit without inquiry, and keeping tabs on the whereabouts of the original copy of the letter of credit, can present challenges. However, where the security is large, the added administration may be worth it when compared to the time and expense of bringing an action to prove damages under a guarantee or indemnity. The extra administration would surely have been preferable to the results encountered by the landlord in *Alignvest Private Debt Ltd. v. Surefire Industries Ltd.* (in which, as explained in our March 2016 *News ReLease*, upon the insolvency of the tenant, the landlord was required to return a $3.2 million security deposit for distribution to the tenant's other creditors).

## ANNOUNCEMENTS

***Daoust Vukovich LLP** is pleased to announce that **CANDACE COOPER has been admitted to partnership**. Candace was called to the Ontario Bar in 2007 and admitted to the New York State Bar in 2008. Candace joined the firm as an associate lawyer in 2012. Candace has dedicated her career to all areas of commercial real estate law, including acquisitions, dispositions, financing and development of land involving commercial, retail and industrial properties.*

***Daoust Vukovich LLP** is also pleased to announce that **JEANNE BANKA** has been included in the **2017 Lexpert American Lawyer Guide to the Leading 500 Lawyers in Canada,** joining DENNIS DAOUST and NATALIE VUKOVICH in the Property Leasing category. We congratulate Jeanne on this impressive and well-deserved recognition. Most notable is the fact that three of the eight lawyers in this all-Canada category are members of Daoust Vukovich LLP - more than any other law firm in Canada.*




MARY ANN BADON
416-598-7056
mbadon@dv-law.com

FRANCINE BAKER-SIGAL
416-597-8755
francine@dv-law.com

JEANNE BANKA
416-597-0830
jbanka@dv-law.com

CANDACE COOPER
416-597-8578
ccooper@dv-law.com

DENNIS DAOUST
416-597-9339
ddaoust@dv-law.com

BITALI FU
416-598-7053
bitalif@dv-law.com

GASPER GALATI
416-598-7050
ggalati@dv-law.com

S. RONALD HABER
416-597-6824
rhaber@dv-law.com

ANDREW JOHNSTON
416-479-4357
ajohnston@dv-law.com

WOLFGANG KAUFMANN
416-597-3952
wolfgang@dv-law.com

MIMI LIN
416-597-8493
mimil@dv-law.com

MELISSA M. MCBAIN
416-598-7038
mmcbain@dv-law.com

JENNA MORLEY
416-597-9225
jmorley@dv-law.com

PORTIA PANG
416-597-9384
ppang@dv-law.com

JAMIE PAQUIN
416-598-7059
jpaquin@dv-law.com

BRIAN PARKER
416-591-3036
bparker@dv-law.com

ALICE PERALTA
416-597-1536
aperalta@dv-law.com

LUCIA TEDESCO
416-597-8668
ltedesco@dv-law.com

NATALIE VUKOVICH
416-597-8911
nvukovich@dv-law.com

DANIEL WALDMAN
416-597-9306
dwaldman@dv-law.com

D'EBORAH A. WATKINS
416-598-7042
dwatkins@dv-law.com