- Online ABI Journal
- **Current Issue**
- ABI Journal Archives
- Submission Guidelines
- Column Descriptions (pdf)
- 2006 Article Deadlines (pdf)
- Advertising
- ABI Law Review
- ABI Update Newsletter
- Cracking the Code
- West Bankruptcy Newsletter
- Collier Case Update
- Bookstore

PRINT THIS PAGE

E-MAIL THIS PAGE

Home → Publications → Online ABI Journal → Current Issue

Are Letters of Credit Covered by the Landlord's Cap?

Written by:
Michael St. James[1]
St. James Law, P.C.; San Francisco
michael@stjames-law.com

FEATURE ARTICLE

Section 502(b)(6) establishes an arbitrary limitation on the amount of a landlord's claim in a tenant bankruptcy case, ordinarily one year's rent (the "landlord's cap"). Case law, supported by the legislative history of the Bankruptcy Code, provides that any security deposit held by the landlord must be applied against the landlord's cap, reducing or eliminating the landlord's claim against the bankruptcy estate.

Until recently, there had been an active debate about whether the courts would apply the proceeds of a letter of credit against the landlord's cap in the same manner as a security deposit, or would reach the opposite result based on the "independence principle" applicable to letters of credit. A Bankruptcy Appellate Panel (BAP) and three circuit appeals courts have now addressed the issue, the Fifth and Ninth Circuits having ruled within the past several months. Unfortunately, they have not adopted a consistent and coherent overall analysis, and as a consequence the decisions have only limited predictive value.

Summary of the Decisions

Case law on this subject is dominated by a 1942 decision of the Second Circuit, *Oldden v. Tonto Realty Co.*,[2] which addressed the landlord's cap under the then-newly enacted Chandler Act. Without statutory, decisional or policy support, the Second Circuit concluded that a landlord's security deposit should be applied against the landlord's cap, rather than the landlord's excess damages (the "*Oldden* Rule"). In the ensuing years, *Oldden* was regularly cited for its characterization of the policy underlying the landlord's cap, but until the decisions discussed in this article, no subsequent circuit appeals court expressly approved or explained the *Oldden* Rule. The legislative history to §502(b)(6) stated, however, that the Code was not expected to alter the *Oldden* Rule. But for that favorable citation in the legislative history,

it was possible that case law as it developed under the Code would reject the *Oldden* Rule as misguided.[3]

The first of the recent cases is a 2003 decision of the Third Circuit Court of Appeals. In *PPI Enterprises*,[4] the tenant defaulted, and the landlord terminated the lease, applied its letter of credit and then pursued the tenant for the balance of its loss. Many years later, the tenant filed bankruptcy, proposing to pay the landlord's allowed claim in full after application of the landlord's cap. Among the issues on appeal was whether the proceeds of the letter of credit should be treated like a security deposit, reducing the landlord's cap. After canvassing the conflicting positions, the Third Circuit explained that it was "not inclined to disturb the rationale" of *Oldden*—that is, it was inclined to treat letters of credit in the same manner as security deposits—but concluded that it "need not decide the underlying question because it is clear the parties intended the letter of credit to operate as a security deposit," and so, like a cash security deposit, the proceeds of the letter of credit must be treated as reducing the landlord's cap.[5]

In *Mayan Networks*,[6] the Ninth Circuit BAP focused on the fact that the tenant had obtained the letter of credit for the landlord by pledging a certificate of deposit in an identical amount as collateral for its reimbursement obligation to the issuing bank. When the landlord drew on the letter of credit, the bank offset the certificate of deposit, which constituted property of the bankruptcy estate and would have been returned to the bankruptcy estate but for the draw on the letter of credit. The BAP concluded that "the appropriate analysis looks to the impact that the draw upon the letter of credit has on property of the estate."[7] In *Mayan Networks*, the effect of the draw on the letter of credit was identical to the application of a security deposit (due to the pledge of the certificate of deposit), so the proceeds of the letter of credit were treated as reducing the landlord's cap; had there been no pledge of property of the estate respecting the letter of credit, the opposite result would be obtained.[8] In a thoughtful and persuasive concurring opinion, Judge Klein presented a thorough analytical framework to address letters of credit as a species of guarantor and surety liabilities under the Bankruptcy Code.[9]

Thereafter, in *AB Liquidating Corp.*,[10] the Ninth Circuit tersely held that the proceeds of a letter of credit reduce the landlord's cap where the letter of credit is supported by a pledged certificate of deposit in equivalent amount. The Ninth Circuit expressly refused to adopt or reject the analysis proposed by Judge Klein or to provide its own analysis.[11]

Finally, in *Stonebridge Technologies Inc.*,[12] the landlord's letter of credit exceeded the amount of the landlord's cap and the bankruptcy estate sought to recover the excess. The Fifth Circuit suggested that the landlord's cap should not be interpreted as an avoidance right but concluded that the landlord's cap was not applicable to a draw on a letter of credit where the landlord does not file a proof of claim.

Four Analytical Approaches

These decisions present four very different analyses for determining the interaction between the landlord's cap and letter-of-credit proceeds: two formal, two substantive.

The Name Governs. One formal approach, adopted explicitly by the Third Circuit[13] and implicitly by the Ninth Circuit,[14] is to look to the description of the letter of credit in the lease; if it is referred to as a "security deposit," it will be applied against the landlord's cap.

The Claim Governs. A similarly formal approach was adopted by the Fifth Circuit: If the landlord files a proof of claim, the landlord's cap applies; if the landlord does not file a proof of claim, the bankruptcy process does not interact with the landlord or the letter of credit.[15]

The Impact on the Estate Governs. The Ninth Circuit BAP,[16] the Third Circuit[17] and implicitly the Ninth Circuit[18] found the treatment of the issuing bank's reimbursement claim against the debtor significant. The BAP concluded that where the reimbursement claim was secured by cash property of the estate, it effectively converted the letter of credit into a security deposit, requiring application against the landlord's cap;[19] the Ninth Circuit apparently adopted this view as well.[20] The BAP thought the opposite result would apply where the reimbursement claim was unsecured,[21] but the Third Circuit concluded that the existence of any reimbursement claim, even if unsecured, was sufficient to require application of the letter of credit proceeds to the landlord's cap.[22]

Surety and Subrogation Law Governs. In sharp contrast to the rather shallow and case-specific analyses proposed by the appellate courts, Judge Klein's extensive analysis in his concurring BAP decision in *Mayan Networks* rationalizes the issue in terms of suretyship and subrogation law in the bankruptcy context generally.[23] The general approach of the Code is to allow the primary creditor to assert his claim against the estate, notwithstanding collections from guarantors, until the claim has been completely satisfied. Guarantors, on the other hand, may assert claims against the estate only to the extent that they have satisfied the claim of the primary creditor and the claim of the primary creditor would have been allowed, essentially viewing the guarantor as holding the equivalent of a subrogation right.[24] Thus, ordinarily[25] the bank's reimbursement claim would be disallowed under Judge Klein's analysis, because the landlord will ordinarily consume the entire landlord's cap through its own claim against the estate and there will be no additional allowed landlord claim to which the bank could succeed.[26] Judge Klein honors the "effect on the estate" analysis by disallowing the bank's reimbursement claim (to the extent that it, together with any claim allowed to the landlord, exceeds the amount of the landlord's cap) and by requiring a return of the collateral securing the bank's disallowed reimbursement claim.[27]

What Was (Probably) Resolved

The appellate courts' failure to adopt—or even to articulate—a consistent, coherent analysis and the implicit split in the circuits based on their divergent approaches leave few issues conclusively resolved. A few things have largely been resolved, though.

First and foremost, where the tenant has pledged an equivalent amount of cash to secure its reimbursement obligation to the issuing bank, the proceeds of the letter of credit will be applied to reduce the landlord's cap in determining the amount of the landlord's general unsecured claim in the tenant's bankruptcy case. Indeed, this is the only "rule" common to or consistent with all four of the decisions.

Second, the courts are likely generally to treat *Olddden* as persuasive authority, requiring that security deposits—and probably letter-of-credit proceeds—be applied against and reduce the amount of the landlord's cap. In *PPI Enterprises*, the Third Circuit adopted *Olddden*, albeit in a lukewarm manner.[28] Thereafter, the Ninth Circuit expressly adopted *Olddden*, holding that the legislative history "eviscerates" any attempt to re-think *Olddden*.[29] (The BAP also accepted the application of *Olddden* in the security-deposit setting,[30] although Judge Klein's concurring opinion counseled against using *Olddden* as a "talisman."[31]) On the other hand, the Fifth Circuit did not mention the case, provided no clear guidance on its continued vitality and adopted an analysis that contradicted aspects of the *Olddden* decision.[32] Thus, it is possible only to say that *Olddden* is probably the law.

Finally, the analytical core of the landlords' position was rejected by most of the courts. The landlords' "silver bullet" was the "independence principle" that treats a letter of credit as a separate contract between the landlord and the issuing bank, a contract that is out of the reach of the bankruptcy process. Landlords argued that just as they were free to apply recoveries from a guarantor without regard to the landlord's cap,[33] so they should be permitted to apply the proceeds of a letter of credit in the same manner due to the independence principle. With one exception, none of these cases found the independence principle a particularly compelling factor in the analysis.[34] The odd man out was Stonebridge Technologies: Howard Rubin, counsel for the landlord in that case, asserts that the critical holding of the case is that the independence principle is alive, well and controlling in the Fifth Circuit.[35] On the other hand, the decision's focus on whether a proof of claim was filed suggests that where the letter of credit is less than the landlord's cap and the landlord seeks a recovery from the bankruptcy estate, the "independence principle" may not drive the analysis, even in the Fifth Circuit.

What Is Left Undecided

The four decisions afford little predictive value, due to the absence of a single coherent analysis. This can be seen most dramatically by considering two common and leading

examples.

First, assume a letter of credit in excess of the landlord's cap backed by a pledge of an equivalent certificate of deposit, as was the case in *Stonebridge Technologies*. In the Ninth Circuit, it seems probable that the bankruptcy estate could require the landlord to refund the excess. This is so because the Ninth Circuit has expressly adopted *Oldden*, and the *Oldden* decision discussed the possibility of a security deposit that exceeded the landlord's cap and concluded that "anything in excess should go to the trustee for the general creditors."[36] While *Oldden* explicitly dealt only with security deposits, the Ninth Circuit holds that letters of credit backed by pledges of cash or certificates of deposit are identical to security deposits in practical effect and hence subject to application of the *Oldden* Rule. In the Ninth Circuit, the bankruptcy estate would seem clearly to have a right to recover the excess letter of credit proceeds.[37]

It is not at all clear what result would apply in the Third Circuit. The Third Circuit expressed only lukewarm support for *Oldden*,[38] and it has not expressly held that letters of credit are equivalent to security deposits, except in cases where the lease defines the letter of credit as a "security deposit." While *PPI Industries* certainly suggests that the Third Circuit was not uncomfortable with the application of *Oldden* to a letter of credit in one context, it was never forced to address the seemingly anomalous circumstance of using the landlord's cap as an avoiding power to recover the bank's payment to the landlord, a circumstance that tests almost any analysis.[39] The Third Circuit could easily adopt the "landlord's cap is not an avoidance power" approach or Judge Klein's analysis or some other alternative. There is no sound basis on which to predict what it would do in response to the "excess proceeds" fact pattern.

Even in the Fifth Circuit, where the issue has been squarely addressed, the dispositive factor is unclear. On the one hand, the Fifth Circuit remarked that the landlord's cap was not enacted as an avoiding power but as a limitation on claims,[40] a holding sufficient to bar recovery of the excess proceeds in every case. On the other hand, the Fifth Circuit relied heavily on the fact that the landlord had not filed a proof of claim, electing instead to remain apart from the bankruptcy process.[41] This point seems reminiscent of *Katchen v. Landy*[42] and *Langenkamp v. Culp*,[43] which hold that the filing of a proof of claim converts all litigation with the claimant into an aspect of the "restructuring of the debtor-creditor relationship," within the scope of the bankruptcy court's summary equity jurisdiction, even when the estate seeks to recover an amount in excess of the claim from the claimant, as was the case in *Stonebridge Technologies* and our hypothetical.[44] If the Fifth Circuit was really looking to these cases, the significant factor was the absence of a proof of claim[45] rather than Congress' failure to identify the landlord's cap as an avoidance power.[46]

Second, consider a letter of credit issued as part of the debtor's general banking relationship, secured—along with its

other borrowings from the bank—by a blanket lien that will prove, when the bankruptcy case is ultimately filed, to be undersecured. Must the proceeds of the landlord's draw on the letter of credit be applied against the landlord's cap?

In the Third Circuit, the answer is probably yes, the proceeds of the letter of credit must be applied against the landlord's cap. Although the Third Circuit's discussion was equivocal and, ultimately, dicta, the Third Circuit does not seem to view the nature or extent of the reimbursement right as significant: Whether secured or unsecured, the mere existence of the bank's reimbursement claim represents a potential "end run" around *Oldden*, and the Third Circuit is "not inclined to disturb" the *Oldden* Rule.[47]

In the Ninth Circuit, the result will be much more difficult to determine. There, the existence of a secured reimbursement right is critical, and a letter of credit is considered equivalent to a security deposit because the issuing bank holds a certificate of deposit posted by the debtor in an equivalent amount: Every dollar taken from the letter of credit is a dollar that will be taken from the certificate of deposit, which would otherwise be returned to the estate, and hence the letter of credit is the practical equivalent of a cash security deposit. Where the letter of credit is backed by an undersecured lien, a different result may well apply:[48] To the extent that the reimbursement right was truly secured in the bankruptcy sense,[49] it will apply against the landlord's cap; to the extent that it was undersecured (unsecured in the bankruptcy sense),[50] it will likely not be applied against the landlord's cap.[51] Likewise, the estate's ability to recover proceeds of the letter of credit in excess of the landlord's cap is likely dependent on the bank's reimbursement right respecting those excess proceeds being secured by valuable collateral. Thus, the Ninth Circuit will likely require a difficult analysis of the extent to which the bank's reimbursement claims were undersecured, in order to determine the extent to which proceeds of a letter of credit are applied against the landlord's cap.

The Fifth Circuit is something of a cipher in this regard, since its holding was so narrowly focused on concluding that the landlord's cap has no application in the absence of a filed proof of claim. The opinion makes no reference to *Oldden* and, while *PPI Enterprises* and *Mayan Networks* are cited as standing for the proposition that "other circuits...have treated the proceeds of a letter of credit as a security deposit and capped by §502(b)(6)," there is no hint as to whether the Fifth Circuit would follow those "other circuits" or not.[52] It is only clear that the landlord's cap will not be considered if the landlord does not file a proof of claim.

Conclusion

The extent to which the proceeds of letters of credit will be applied against the landlord's cap is an issue that has been the focus of attention for more than a decade, and on which hundreds of millions of dollars are at stake. In comparatively short order, three Circuit Courts of Appeals and one BAP have

ruled on it. Unfortunately, their insistence on resolving the issue in terms of the specific facts of each case and their refusal to articulate an analysis of general applicability have left the issue almost as uncertain as it was before they spoke.

Footnotes

1 The author was counsel for the landlord in *AB Liquidating Corp*. He expresses his gratitude to Judge **Christopher Klein**, author of the concurring opinion in *Mayan Networks*; Howard Rubin of Dallas, counsel for the landlord in *Stonebridge Technologies*; and Ivan Gold of San Francisco, all of whom provided thoughtful responses to earlier drafts of the article.
2 143 F.2d. 916 (2d Cir. 1944).
3 In the *AB Liquidating* briefing, the author unsuccessfully urged that the Ninth Circuit reject *Oldden*. *See*, *generally*, St. James, "*Oldden*, Letters of Credit and §502(b)(6)" 26 Cal. Bankr. J. 307 (2003).
4 *Solow v. PPI Enterprises Inc.* (*In re PPI Enterprises Inc.*), 324 F.3d 197 (3d Cir. 2003).
5 *PPI Enterprises*, 324 F.3d. at 209-10.
6 *Redback Networks, Inc. v. Mayan Networks Corp.* (*In re Mayan Networks Corp.*), 306 B.R. 295 (BAP 9th Cir. 2004).
7 *Mayan Networks*, 306 B.R. at 299.
8 *Mayan Networks*, 306 B.R. at 299-300.
9 *Mayan Networks*, 306 B.R. at 301, et seq.
10 *AMB Property L.P. v. Official Creditors for the Estate of AB Liquidating Corp.* (*In re AB Liquidating Corp.*), 416 F.3d. 961 (9th Cir. 2005).
11 *AB Liquidating*, 416 F.3d. at 965.
12 *EOP-Colonnade of Dallas Limited Partnership v. Dennis Faulkner* (*In re Stonebridge Technologies Inc.*), 430 F.3d. 260 (5th Cir. 2005).
13 *PPI Enterprises*, 324 F.3d. at 210.
14 *AB Liquidating*, 416 F.3d. at 961 (characterizing the case as involving a "letter of credit security deposit").
15 *Stonebridge Technologies*, 430 F.3d. at 269-270. Curiously, the Fifth Circuit did not view pursuing payment of administrative rent in the bankruptcy case—which the landlord did in the *Stonebridge Technologies* case—as having an impact on the issue.
16 *Mayan Networks*, 306 B.R. at 299-300.
17 *PPI Enterprises*, 324 F.3d. at 209 (characterizing the reimbursement claim as an "end run around §502(b)(6)").
18 *AB Liquidating*, 416 F.3d at 965, n. 3.
19 *Mayan Networks*, 306 B.R. at 299.
20 *AB Liquidating*, 416 F.3d at 965, n. 3.
21 *Mayan Networks*, 306 B.R. at 300.
22 *PPI Enterprises*, 324 F.2d at 209 (expressing concern that otherwise the debtor "would be liable twice for the same amount of money").
23 It should be noted that the Ninth Circuit expressly held open the possibility that it would adopt Judge Klein's analysis. *AB Liquidating*, 416 F.3d at 965.
24 *Mayan Networks*, 306 B.R. at 307 et seq. (Klein,

concurring); also, see 11 U.S.C. §§502(e) and 509.
25 Judge's Klein's analysis is a concurrence rather than a dissent because the letter of credit at issue in *Mayan Networks* peculiarly required the landlord to receive, hold and apply the proceeds of the letter of credit as though they were a security deposit. In the ordinary case, the application of the proceeds are not likely to be so circumscribed.
26 "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." *Mayan Networks*, 306 B.R. at 310 et seq. (Klein, concurring).
27 The "seamless web" that Judge Klein articulates so well seems to collapse at this point through legislative fiat. Although as a general matter of bankruptcy law where a claim is disallowed, collateral securing that claim must be returned to the bankruptcy estate, in §506(d) Congress provided that collateral securing a reimbursement right could not be recovered where the underlying claim was disallowed.
28 *PPI Enterprises*, 324 F.3d. at 209 ("we are not inclined to disturb the rationale followed since *Oldden*").
29 *AB Liquidating*, 416 F.3d. at 964.
30 *Mayan Networks*, 306 B.R. at 299 ("it is clear that security deposits are to be applied after the §502(b)(6) cap...").
31 *Mayan Networks*, 306 B.R. at 310 et seq. (Klein, concurring).
32 *Contrast Stonebridge Technologies*, 430 F.3d. at 270, with *Oldden*, 143 F.2d. at 921.
33 *In re Modern Textile Inc.*, 900 F.2d. 1184, 1191 (8th Cir. 1990) ("the liability of a guarantor for a debtor's lease obligations is not altered by the trustee's rejection of the lease"); *In re Western Real Estate Fund Inc.*, 922 F.2d. 592, 601 (10th Cir. 1990) (bankruptcy does not "bar litigation against third parties for the remainder of the discharged debt...[even where] the creditor's claim is based on an executory contract that is both rejected under §365(a) and subject to limitation in amount [by §502(b)(6)]"; *Bel-Ken Associates Ltd. Partnership v. Clark*, 83 B.R. 357 (D. Md. 1988) (guarantor obligation not affected by tenant's bankruptcy and its invocation of §502(b)(6)); *In re Empire Knitting Mills Inc.*, 123 B.R. 688, 691 (Bankr. D. Me. 1991) (§506(b) does not limit recovery against a guarantor when the debtor rejects a lease).
34 *See, e.g.*, *Mayan Networks*, 306 B.R. at 299 ("the fact that letters of credit themselves are not property of the estate is a red herring").
35 "Insofar as letters of credit embody obligations between the issuer and beneficiary, such contractual rights and duties are entirely separate from the debtor's estate." *Stonebridge Technologies*, 430 F.3d. at 269.
36 *Oldden*, supra, 143 F.2d at 921.
37 Except that under Judge Klein's analysis, they would be recovered from the certificate of deposit pledged to the bank.
38 See note 27, *supra*.
39 Except, of course, Judge Klein's robust analysis that folds the treatment of letters of credit into the treatment of surety claims in bankruptcy generally, and thus provides a means of analyzing each of the various fact patterns. *Mayan Networks*, 306 B.R. at 301 et seq.
40 *Stonebridge Technologies*, 430 F.3d. at 270.

41 *Stonebridge Technologies*, 430 F.3d. at 269-270.
42 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d. 391 (1966).
43 498 U.S. 42, 45, 111 S.Ct. 330, 112 L.Ed.2d. 343 (1990).
44 On the other hand, seeking recovery of administrative rent; *see* note 14, *supra*, would have constituted a submission to the summary jurisdiction of the bankruptcy court for the purposes of *Katchen v. Landy* and *Langenkamp v. Culp.*
45 Query whether the debtor or the bank can change the result by filing a proof of claim on behalf of the landlord. 11 U. S.C. §501(b) and (c).
46 Of course, the avoidance claims in *Katchen v. Landy* and *Granfinanciera* existed independent of the proof of claim and could have been prosecuted in the absence of a proof of claim; they would simply have been prosecuted in the district court, where there was plenary jurisdiction. Taking the Fifth Circuit's reliance on the absence of a proof of claim seriously, however, suggests that the existence of the cause of action, rather than merely jurisdiction to determine the cause of action, is dependent on the existence of the proof of claim.
47 *PPI Enterprises*, 324 F.3d. at 209.
48 *Mayan Networks*, 306 B.R. at 300 (noting that the opposite result would apply where the bank's reimbursement right was unsecured).
49 11 U.S.C. §506(a).
50 11 U.S.C. §506(d).
51 The Ninth Circuit adopted this analysis in a comparable setting. In *Creditors' Committee v. Koch Oil Co.* (*In re Powerine Oil Co.*), 59 F.3d. 969 (9th Cir. 1994), a preference defendant asserted that its release of its claim against a letter of credit constituted new value. There, the reimbursement right was backed by an undersecured blanket lien on the assets of the debtor. The Ninth Circuit held that the new-value defense was limited to the secured portion of the bank's reimbursement claim against the debtor's collateral, and was not available to the extent that the bank's reimbursement claim was unsecured.
52 *Stonebridge Technologies*, 430 F.3d. at 270-71.