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## Landlords draws upon letters of credit in bankruptcy: Redback Networks v Mayan Networks, 2004

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**Landlords draws upon letters of credit in bankruptcy:  
*Redback Networks v Mayan Networks, 2004*  
Roger Bernhardt**

**Draw upon letter of credit given as security for lease by debtor reduced amount of landlord's allowed claim under 11 USC §502(b)(6) when debtor pledged cash to bank to secure letter of credit.**

*Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295

In January 2000, Debtor subleased a large commercial building from Landlord. Debtor provided two forms of security for the sublease: \$351,033 in cash and a letter of credit for \$648,966 issued by Bank. Debtor pledged over \$650,000 cash to Bank to secure the letter of credit. In November 2001, Debtor filed a Chapter 11 petition and moved to reject the sublease. Landlord filed a general unsecured claim for damages arising from the rejection of the sublease and an administrative claim for post-petition rent. Landlord agreed to apply the cash security deposit to reduce its allowed claim as capped by 11 USC §502(b)(6). Under §502(b)(6), Landlord was limited to post-petition rent of one year. The bankruptcy court held that the allowed claim as capped by §502(b)(6) should be reduced by the amount of the letter of credit. Landlord appealed, maintaining that it should be able to apply the proceeds from the letter of credit to its damage claim before application of the §502(b)(6) cap.

The bankruptcy appellate panel affirmed, finding that §502(b)(6) was ambiguous because it was not clear whether the allowable claim is the total amount of damages that a landlord may recover or the amount that the landlord may claim against the bankruptcy estate in addition to any security that has been recovered. The court explained that, although it was clear that security deposits are to be applied after the §502(b)(6) cap, thus reducing the unsecured claim that a landlord may have against the estate, the question remained whether the letter of credit was to be treated like a security deposit.

The court determined that the letter of credit should be treated as a security deposit. Although the court agreed that the letter of credit was not property of the estate, the court characterized that fact as a “red herring,” pointing out that nothing in the statute or in case law suggested that the limitation in §502(b)(6) applied only to amounts that are paid directly from property of the estate. The appropriate analysis should look to the effect that the draw upon the letter of credit had on property of the estate: In this case, the \$650,000 cash pledged to Bank was property of the estate and was used in effect to pay Landlord. The court concluded that inserting the Bank between Debtor and Landlord could not change the true nature of the arrangement, which was to provide a security deposit. Because the letter of credit was the equivalent of a security deposit, it applied after the §502(b)(6) cap.

***THE EDITOR'S TAKE:*** In this case, the landlord drew on a letter of credit, posted by the tenant as security for the lease, that was smaller than the amount of its rent claim and also smaller than a year's rent. The landlord was permitted to draw down the full letter of credit

(since it was owed more than that), and was then treated as an unsecured creditor for the balance owing to it. That result changes if the comparative numbers are different.

For example, suppose the annual rent is \$1 million and the landlord's rent claim is for \$800,000, and she holds a letter of credit for \$1.3 million (*i.e.*, greater than either the rent claim or the annual rent, unlike the facts in *Mayan Networks*). She may draw down \$800,000 of her letter of credit to cover her damages. (And the bank that issued the letter may then either look to its own collateral for repayment, or else go after the tenant in bankruptcy for the \$800,000 it paid to the landlord.)

Suppose the annual rent is \$1 million and the landlord's rent claim is for \$1.8 million, and she holds a letter of credit for \$600,000. It is clear that she can draw down the entire letter, but what happens next? She does not have a claim for \$1.2 million, because it is capped by the annual rent (under 11 USC §502(b)(6)) of \$1 million; but is she allowed \$1 million or only \$400,000—*i.e.*, does the draw on the letter count against the cap? Last year, although the Third Circuit held that the draw on the letter does count against the cap, the Ninth Circuit BAP held, in *Young v Condor Sys., Inc. (In re Condor Sys., Inc.)* (BAP 9th Cir 2003) 296 BR 5, that it did not. But here the BAP limits *Condor Systems* to cases where the issuer of the letter of credit was not a secured creditor of the debtor. That means that in a normal lease-security case where the tenant posts security to the bank in order to have it issue a letter of credit to the landlord, a draw on the letter of credit will be applied against the cap. Thus, in this scenario, the landlord has only a \$400,000 allowed claim remaining (assuming there are sufficient assets in the tenant's bankruptcy estate to make any of this matter).

Suppose the annual rent is \$1 million and the rent claim is still \$1.8 million, but now the letter of credit is for \$1.2 million. Notwithstanding the cap, the landlord may draw on the letter in full. Because of the independence principle, the letter of credit is not part of the tenant's estate and a third party issuer is not protected by the cap. However, since the draw on the letter of credit by the landlord is credited against the cap, that is the extent of the landlord's recovery—she cannot even get the proverbial ten cents on the dollar for the remaining \$600,000 that she is owed. Additionally, the issuer's right to reimbursement from the tenant is also subject to the cap; so the bank, if it was unsecured, may have to pay the landlord \$1.2 million and be able to recover only \$1 million from the tenant's estate. (All of this is also true in a scenario in which the letter of credit exceeds both the rent claim and the annual rent.) —*Roger Bernhardt*