PRESENTED AT

2017 Bernard O. Dow Leasing Institute

November 10, 2017
Houston, Texas

Utilizing Letters of Credit as Security in Lease Transactions

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Most commercial leases require landlords to make substantial initial investments, including by designing and constructing tenant improvements, advancing tenant improvement allowances and paying leasing commissions. In order to protect these investments prudent landlords pay close attention to the creditworthiness of their prospective tenant. Absent investment grade credit tenants it is typical for landlords to seek security to ensure repayment of these investments. While cash security deposits and lease guaranties from creditworthy entities have traditionally dominated these arrangements, landlords and tenant have increasingly sought more flexible means by which to provide landlord with security for its leasehold investments. It is in this context that the use of letters of credit as a form of security for lease obligations in lieu of the more traditional cash security deposits has grown. While cash deposits are certainly a very functional form of security that is easily accessible to a landlord in the event of tenant default under its lease, and a guaranty from an affiliate with a substantial net worth may be sufficient, the reality in the marketplace is that not every prospective Tenant has enough liquid capital on hand or a sufficiently creditworthy and willing affiliate to act as guarantor. High tech startups are a prime example of the type of entity which is ill-suited to providing a cash security deposit or a guaranty of its obligations, often requiring substantial space to operate and lacking a substantial net worth or needing to maintain liquidity. Moreover, in today's fast changing economy a supposedly creditworthy guarantor can suffer a setback. Additionally, lease guaranties can also be difficult and time consuming to enforce and to collect upon. Meanwhile, letters of credit provide a mean by which landlords can obtain a highly liquid, easily collectible form of security deposit backed by a financial institution. A letter of credit arrangement can offer some significant benefits and flexibility to both landlord and tenant.

Definition of a Letter of Credit

In plain language, a letter of credit is a three party financial instrument pursuant to which a financial institution, referred to as the issuer, agrees to pay to the landlord, the beneficiary of the letter of credit, certain sums for the benefit of the tenant, referred to as the applicant. Financial institutions assess the risk presented in issuing the letter of credit for the benefit of the applicant, charge a fee for doing so and obtain security from the applicant to ensure repayment should the letter of credit be drawn upon by the beneficiary. Upon issuance of a letter of credit the issuer is irrevocably obligated to pay to the beneficiary up to the specified amount of the letter of credit, if the beneficiary presents the letter of credit to the issuer for a payment prior to the expiration date of the letter of credit. As a result of this type of transaction, landlord is able to look to the financial institution rather than the tenant for payment of amounts due to landlord. Following a draw upon a letter of credit the issuer looks to the tenant applicant for repayment in accordance with the terms of credit documents entered into between the applicant and the issuer to secure repayment of draws upon the letter of credit.

There are two principal types of letters of credit. The classic form is a "Documentary Credit", which has been used the world over to help mitigate the risk of shipping and receiving goods. The Documentary Credit is issued with the parties intending to have the credit drawn upon to consummate the transaction and as such is principally used to secure payment rather than as a form of security for performance. The second type of Letter of credit is known as a "Standby Letter of Credit". As the name suggests, this type of letter of credit is used as a standby to secure performance of an obligation, or in the context of a commercial lease, many different obligations over an extended period of time.

Because financial institutions are in the business of evaluating risk and offering credit to those who they deem a good financial risk, they are in a position superior to landlords when comes

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First appeared as part of the conference materials for the
2017 Bernard O. Dow Leasing Institute session
"Utilizing Letters of Credit as Security for Lease Transactions"