

**LETTERS OF CREDIT AND 11 U.S.C. § 502(b)(6):
THE FULL ANALYSIS**

**WHY THE FIFTH CIRCUIT'S DECISION IN *IN RE
STONEBRIDGE* IS ONLY PART OF THE ANSWER**

INTRODUCTION

When a tenant holding a long-term leasehold on commercial real property files under the U.S. Bankruptcy Code (“Bankruptcy Code”), it creates significant financial and legal issues for the landlord, the estate of the debtor, and the other creditors of the estate. Assuming the bankruptcy filing results in a breach of a lease,¹ the landlord is left holding a claim against the estate in an amount potentially equal to the unpaid rent for the balance of the lease term. If the lease term is long, such as fifty or one hundred years, the landlord’s claim would significantly diminish the chances of any recovery from the estate by other unsecured creditors.

To protect against this perceived inequitable result, Congress fashioned a draconian remedy within the Bankruptcy Act of 1898, which simply disallowed landlords’ claims for prospective rent.² It was not until 1934 that Congress realized barring landlords from holding any claim at all might be equally unjust.³ The result was new legislation,⁴ which became the precursor to the current version of § 502(b)(6) of the Bankruptcy Code, which now provides landlords a limited right to share in the estate.⁵ However, the language and interpretation of this particular provision has been the subject of much debate and some questionable judicial analysis.

¹ When a tenant files for bankruptcy and either surrenders the premises in violation of the lease or rejects the lease pursuant to the Bankruptcy Code, it equates to a breach of the lease. *See* 11 U.S.C. § 365(g) (2000).

² Landlords could not share in the distribution of the bankruptcy estate, and their claims could not be discharged in bankruptcy. *Vause v. Capital Poly Bag, Inc. (In re Vause)*, 886 F.2d 794, 802 (6th Cir. 1989).

³ *See* Michael St. James, *Oldden, Letters of Credit and Section 502(b)(6)*, 26 CAL. BANKR. J. 307, 312 (2003).

⁴ Municipal Bankruptcy Act of 1934, Pub. L. No. 251, 48 Stat. 788 (1934) (amended 1937).

⁵ *See* 11 U.S.C. § 502(b)(6).

The debate centers around how much security a landlord may acquire (and ultimately keep) to insure its projected stream of rental income after a tenant defaults and thereafter seeks shelter behind the walls of bankruptcy. A landlord of commercial real property will often require its tenant to post a security deposit. Traditionally, the tenant provides the landlord with a cash security deposit, which may or may not be refundable to the tenant upon successful completion of the lease term. Cash, however, is not the landlord's only option. In recent years, an increasing percentage of security deposits have been created using a standby letter of credit.⁶

A standby letter of credit,⁷ like a security deposit, provides assurance for the performance of an obligation.⁸ A letter of credit provides for payment by a third party to one party to a contract when the other contracting party fails to perform its obligation.⁹ There are typically three parties to a letter of credit: the issuer (usually a bank), the applicant (the tenant, for present purposes), and the beneficiary (the landlord).¹⁰ The tenant pays the bank a fee and provides a reimbursement agreement for the bank to issue the letter of credit for the landlord's benefit.¹¹ If the tenant defaults on his obligations under the lease, the landlord may draw upon the letter of credit, i.e., request payment, and the bank is obligated to pay the landlord.¹²

A landlord has two primary options to secure his interest in a lease, which may be used together or separately—a cash security deposit and a letter of credit.¹³ However, in light of the Bankruptcy Code, as interpreted by those courts that have addressed the issue, there exists significant doubt as to whether the landlord can ever fully secure the financial obligations undertaken by a tenant under a long term lease. The Bankruptcy Code¹⁴ provides a

⁶ The dollar value of standby letters of credit issued in 1980 by U.S. and foreign banks was \$51 billion combined. Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 102, n.121 (1999). The outstanding value of standby letters of credit as of 1999 was approximately \$250 billion in the United States alone and almost \$500 billion worldwide. *Id.*

⁷ All letters of credit referred to in this Comment are standby letters of credit.

⁸ BURTON V. MCCULLOUGH, *Introduction to LETTERS OF CREDIT* § (II)(B) (perm. ed., rev. 2005).

⁹ *Id.*

¹⁰ *Id.* § 2.05(1).

¹¹ *Id.* § 3.01.

¹² Payment on a standby letter of credit requires only the presentation of documents specified in the letter of credit, not proof of the applicant's default. *Id.* § (II). However, a landlord who improperly draws on a letter of credit may be subject to claims by the tenant based upon breach of contract, fraud, or other grounds. *Id.* § 2.05.

¹³ See Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 734 (2001).

¹⁴ 11 U.S.C. § 502(b)(6) (2000).

statutory limit on the amount of damages a landlord can recover against a debtor's estate for unpaid rent resulting from the termination of a lease of real property (the "Cap").¹⁵ The Cap limits the landlord's damages to the greater of one year's rent or 15% of the total rent due for the remaining term of the lease, not to exceed a maximum term of three years.¹⁶ Depending on the amount of security being held by a landlord, two possible scenarios emerge from application of the Cap: (1) the landlord holds a security deposit, as either cash or a letter of credit, in an amount less than the Cap; or (2) the landlord holds security in an amount greater than the Cap.

In the first scenario, the landlord's claim is bifurcated into a secured and unsecured portion.¹⁷ The security deposit represents the secured claim, and the amount of the unsecured claim is the difference between the capped amount and the security deposit.¹⁸ This is the more common of the two scenarios, and the landlord's right to keep the entire security deposit therein has been unchallenged.¹⁹ The second scenario, in which the landlord holds a security deposit in an amount greater than the Cap, is far less common but creates an interesting dilemma. The issue is whether the landlord should be allowed to keep his full security deposit, which he bargained for and acquired prior to bankruptcy, or whether the Cap should be interpreted to require the return of the security in excess of the Cap.²⁰ When the landlord holds a cash security deposit in excess of the Cap, as opposed to a letter of credit, there are strong arguments for the landlord to retain the surplus.²¹ The likely result, however,

¹⁵ This limit on the landlord's claim is known as the "Cap." See, e.g., *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 208 (3d Cir. 2003).

¹⁶ Section 502(b)(6) of the Bankruptcy Code states a landlord's claim is allowed unless such claim exceeds (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

¹⁷ H.R. REP. NO. 95-595, at 354 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6309.

¹⁸ *Id.* For example, if the maximum claim under the Cap was \$100 and the security deposit was \$60, the secured claim would be for \$60 and the unsecured claim would be for \$40. See *id.*

¹⁹ There has been considerable litigation as to whether the security deposit applies to the landlord's gross claim, the claim for damages for the entire lease term before application of the Cap, or to the capped claim. See, e.g., *In re PPI Enters., Inc.*, 324 F.3d at 197; see also discussion *infra* Parts II.A-D. However, in none of these cases did the tenant challenge whether the landlord could retain the entire security deposit. See discussion *infra* Parts II.A-D.

²⁰ The security deposit in excess of the Cap may be referred to as the "surplus" for purposes of this Comment.

²¹ See *infra* Part III.A.

is the landlord will have to disgorge the difference.²² Conversely, when a landlord holds a letter of credit as security, the differences between the letters of credit and cash security deposits effectively negate the disgorgement argument.

In November of 2005, the Fifth Circuit's decision in *EOP-Colonnade of Dallas, Ltd. Partnership v. Faulkner (In re Stonebridge Technologies, Inc.)*²³ overruled all notable precedent when it held a landlord could retain the full proceeds of a letter of credit, regardless of the Cap.²⁴ The court reasoned the Cap did not apply because the landlord never filed a claim for future rent damages.²⁵ This analysis is critical and has been posited by commentators in the past.²⁶ The court, however, ignored many of the issues tackled by the lower courts²⁷ and many of the arguments presented by other commentators.²⁸ The Fifth Circuit's opinion also leaves the state of the law based in form rather than substance.²⁹ This Comment will examine the historical background associated with the landlord's dilemma of security, and then provide the full legal analysis and arguments in support of the proposition that a landlord who holds a letter of credit in excess of the Cap should be entitled to keep the entire amount, whether he files a claim or not.

Part I will cover two topics. Part I.A-B traces the history of the Cap— why it was created, for what purpose, under what circumstances, how it was promulgated, and how it works in practice. Part I.C-D provides an understanding of letters of credit, compares letters of credit to cash security deposits and guaranties, and discusses how letters of credit work in practice.

Part II examines the relevant case law. A brief synopsis of the few pre-*Stonebridge* cases that have addressed the interplay between letters of credit and the bankruptcy limitation on a landlord's claim is outlined in Part II.A-D. Part II.E discusses the Fifth Circuit's *Stonebridge* decision in greater detail. Finally, Part II.F attempts to reconcile all the cases.

²² No cases have addressed this exact issue, but a few have implied this result. See, e.g., *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 921 (2d Cir. 1944).

²³ 430 F.3d 260 (5th Cir. 2005).

²⁴ *Id.* at 271.

²⁵ *Id.*

²⁶ E.g., Winick, *supra* note 13, at 835–36.

²⁷ See *infra* Parts II.A-D, II.F.

²⁸ See, e.g., *infra* notes 101, 165.

²⁹ See *In re Stonebridge Techs., Inc.*, 430 F.3d at 271.

This Comment argues secured landlords should be treated like every other secured creditor. In proving this seemingly obvious proposition, Part III.A explores the arguments in favor of a landlord keeping his security deposit in excess of the Cap, regardless of whether the security deposit is posted as cash or a letter of credit. Part III.A.1 first analyzes *Oldden v. Tonto Realty Corp.*,³⁰ the case that incorporated the Cap into the common law,³¹ and shows the decision is at odds with bankruptcy law and policy. Part III.A.2, a comparison between landlords and mortgagees, will demonstrate that landlords deserve equal treatment with their brethren lenders. Finally, further analysis of *Oldden* and a comparison to mortgagees in Part III.A.3 shows that when the security deposit is greater than the Cap, the landlord should *not* be treated like an over-secured creditor who is required to return the surplus to the estate.

With a firm understanding of the arguments regarding a security deposit generally, an explanation of why letters of credit deserve special treatment in Part III.B further supports the proposition that a landlord should be entitled to retain the full letter of credit proceeds in excess of the Cap. The arguments *against* retaining a *cash* security deposit in excess of the Cap will be addressed by examining the differences between a cash security deposit and a letter of credit. These differences will highlight two key points. First, there is no bankruptcy mechanism for a tenant to recover money properly drawn on a letter of credit, as explained in Part III.B.1. Second, and most importantly, Part III.B.2 will explain why the current judicial reasoning with regard to letters of credit is inadequate for resolving the problem Congress intended to remedy.

Finally, Part IV clarifies the options available for rent security under letters of credit today and announces a new approach. This approach is preferable because it is more equitable to all parties involved, more consistent with bankruptcy law and policy, and addresses the problem Congress intended to resolve.

³⁰ 143 F.2d 916 (2d Cir. 1944).

³¹ “The history of this provision is set out at length in *Oldden . . .*” H.R. REP. NO. 95-595, at 353, *as reprinted* in 1978 U.S.C.C.A.N. 5963, 6319.

I. BACKGROUND

A. *The Historical Evolution of the Bankruptcy Cap*

In analyzing the Cap as it exists and is applied today, it is helpful to understand the evolution of a landlord's remedy in bankruptcy. Prior to 1934, landlords were unable effectively to make a claim for damages for the loss of future rent arising from the termination of a lease.³² In the Bankruptcy Act of 1867, Congress provided a "creditor may prove for a proportionate part [of rent due] up to the time of the bankruptcy,"³³ but did not provide for losses from future rent. The Bankruptcy Act of 1898³⁴ did not even have an express provision on rent, instead relying upon a "remnant of medieval theory,"³⁵ the provable claim.³⁶ If a claim was not provable, it could not share in the distribution of the bankruptcy estate and would not be discharged in bankruptcy.³⁷ Under this standard, courts universally held a landlord's claim for prospective damages was not provable.³⁸

The consequence of applying the provable claim theory was often harsh to both landlord and tenant.³⁹ For example, the landlord was not permitted to share in the bankruptcy distribution, and the debtor was unable to discharge the debt.⁴⁰ Landlords were particularly hard hit during the Great Depression.⁴¹ While their claims survived bankruptcy, most landlords were left holding "valid claims against permanently defunct corporations."⁴² On the other hand, one of the main policies underlying bankruptcy law, to provide a "'fresh' start

³² See *Vause v. Capital Polybag, Inc. (In re Vause)*, 886 F.2d 794, 802 (6th Cir. 1989).

³³ Bankruptcy Act of 1867, ch. 176, § 19, 514 Stat. 517, 525 (1867) (repealed 1878).

³⁴ Nelson Act (Bankruptcy Act of 1898), ch. 541, 30 Stat. 544 (1898) (repealed 1978).

³⁵ *In re Vause*, 886 F.2d at 802 (citations omitted).

³⁶ *Id.* Bankruptcy proceedings extended only to provable claims as opposed to unliquidated and contingent debts. *Id.* Section 63 of the 1898 Act provided "[d]ebts of the bankrupt . . . are (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not." Nelson Act (Bankruptcy Act of 1898), ch. 541, § 63, 30 Stat. 562, 562–63 (1898) (repealed 1978).

³⁷ *In re Vause*, 886 F.2d at 802.

³⁸ *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 918 (2d Cir. 1944).

³⁹ *Id.* at 920.

⁴⁰ *Id.*

⁴¹ *Id.* at 919–20.

⁴² *Id.* at 920.

for ‘honest but unfortunate debtors,’” was frustrated because these exorbitant debts were not dischargeable.⁴³

The Bankruptcy Act of 1934⁴⁴ addressed the unfairness of the provable claim doctrine by making claims for future rent recoverable, but limited them to a maximum of one year’s rent.⁴⁵ As explained in the 1944 *Oldden* decision, Congress attempted to balance three interests with this provision: (1) relief to landlords by making damages for prospective rent a provable claim, (2) relief to bankrupts by making said damages a dischargeable debt, and (3) protection of the remaining creditors from the landlord’s claim depleting the bankruptcy estate.⁴⁶ As the legislative history explains, the Cap was “designed to compensate the landlord for his loss while not permitting a claim so large (based on a long term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate.”⁴⁷ In clarifying this last point, the court distinguished landlords from other creditors:

[T]here is no very compelling reason why [the landlord] should be treated on par with [other general creditors]. For, after all, he has been compensated up until the date of the bankruptcy petition, he regains his original assets upon bankruptcy, and the unexpired term in no way really benefits the assets of the bankrupt’s estate.⁴⁸

The legislative history of the present bankruptcy limitation confirms it is a direct progeny of the 1934 Amendment, the *Oldden* decision, and its interpretation.

The history of this provision is set out at length in *Oldden* This paragraph will not overrule *Oldden*, or the proposition for which it has been read to stand: to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate.⁴⁹

⁴³ CHARLES J. TABB & RALPH BRUBAKER, *BANKRUPTCY LAW: PRINCIPLES, POLICIES, AND PRACTICE* 66 (2003).

⁴⁴ Municipal Bankruptcy Act of 1934, Pub. L. No. 251, 48 Stat. 788 (1934) (amended 1937).

⁴⁵ 4 COLLIER ON BANKRUPTCY ¶ 502.L.H.3[a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed., rev. 2002).

⁴⁶ See 143 F.2d at 920.

⁴⁷ H.R. REP. NO. 95-595, at 353 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6309.

⁴⁸ *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1944).

⁴⁹ H.R. REP. NO. 95-595, at 353–54, as reprinted in 1978 U.S.C.C.A.N., at 6309.

In further explaining the rationale for limiting a landlord's recovery, Congress noted that because the landlord retains all the risk *and benefit* as to the value of the real estate at the termination of the lease, it is equitable to limit the landlord's claim.⁵⁰

B. Calculating the Maximum Allowable Claim Under the Cap

Whether a tenant vacates the premises or rejects the lease, the landlord is entitled to a claim for damages.⁵¹ Damages are calculated under applicable non-bankruptcy state law.⁵² Under state law, the landlord is protected up to the amount of his security deposit regardless of the solvency of the tenant.⁵³ This is not necessarily the case in bankruptcy.⁵⁴

In bankruptcy, the Cap applies to limit the landlord's claim.⁵⁵ Application of the Cap involves three steps. First, the landlord's damages are calculated under applicable state law, taking into consideration issues such as mandatory mitigation.⁵⁶ Any amount a landlord receives by reletting the premises reduces the state law claim before consideration of the Cap.⁵⁷ Second, the maximum amount is calculated according to the formula set forth in the Bankruptcy Code.⁵⁸ Finally, the calculated state law claim from step one is compared to the bankruptcy calculated claim from step two.⁵⁹ If the state law claim is greater than the bankruptcy claim, the claim is reduced for bankruptcy distribution purposes and anything above the Cap is disallowed.⁶⁰

⁵⁰ *Id.*

⁵¹ See Winick, *supra* note 13, at 755–56. This discussion is inapplicable when the tenant assumes the lease in full before any default. *Id.* at 757.

⁵² *Id.* at 761.

⁵³ See *id.*

⁵⁴ *Id.*

⁵⁵ Solow v. PPI Enters., Inc. (*In re* PPI Enters., Inc.), 324 F.3d 197, 207 (3d Cir. 2003).

⁵⁶ *Id.* at 208 n.17.

⁵⁷ *Id.*

⁵⁸ 11 U.S.C. § 502(b)(6) (2000); see *supra* note 14. Courts have generally followed the test set forth in *In re McSheridan* to determine which lease-related charges are included when calculating the Cap. *Kuske v. McSheridan* (*In re* McSheridan), 184 B.R. 91, 99–100 (B.A.P. 9th Cir. 1995). “Rent reserved” under the Cap is any charge that (1) is designated as “rent” or “additional rent” in the lease or provided as an obligation of the tenant in the lease, (2) relates to the value of the property or the lease, and (3) is a fixed, regular or periodic charge. *Id.* For example, prepetition claims for physical damage to the property are not included. See *In re Atl. Container Corp.*, 133 B.R. 980, 993 (Bankr. N.D. Ill. 1991).

⁵⁹ See *In re PPI Enters., Inc.*, 324 F.3d at 207.

⁶⁰ See *id.* “Disallowed,” as used herein, means the claim ceases to exist. It is not placed in a lower tier, nor is it converted to an unsecured claim. This is unlike the claim of most creditors, whom, if they had a gross claim for \$100 and were secured for \$80, would then have an allowed unsecured claim for \$20. See 11 U.S.C. § 506(a). The past due rent under the lease from the earlier of the petition date or date of surrender, however,

The Cap makes no reference to its applicability to guarantors or nondebtor cotenants.⁶¹ Rather, it simply refers to the allowance of a claim for damages recoverable from a bankruptcy estate.⁶² A leading commentary suggests that because the bankruptcy limitation does not “extinguish the lessor’s claim for amounts in excess of the amount chargeable to the debtor’s estate . . . the liability of a nondebtor guarantor or co-tenant is not limited or altered [by this section of the Bankruptcy Code.]”⁶³ This proposition that the landlord may look to the person or entity that guaranteed the debtor’s lease obligation is supported by judicial decisions⁶⁴ as well as the Bankruptcy Code.⁶⁵ Courts have applied the Cap, however, in situations where the guarantor of the lease is the actual debtor, as opposed to the tenant being the debtor.⁶⁶ In these situations, the landlord may not collect more than the Cap amount from the debtor-guarantor simply because he is not the tenant.⁶⁷

C. *The Interplay Between the Cap and a Cash Security Deposit*

Although the language of the Cap is silent as to security deposits,⁶⁸ courts have uniformly held a cash security deposit in the landlord’s possession must be applied against the landlord’s claim as subject to the Cap.⁶⁹ This principle was first announced in *Oldden*, which was decided under the Bankruptcy Act of 1934, where the court was asked to decide whether the landlord’s security deposit should be applied against the landlord’s claim in *excess* of the Cap (i.e., the gross state law claim) or whether it should be applied against and thereby reduce the capped claim.⁷⁰ The House and Senate Reports state a

is treated independently from the Cap and is subsequently added to the amount calculated under step three to arrive at a total claim for the landlord. *In re PPI Enters., Inc.*, 324 F.3d at 207.

⁶¹ COLLIER, *supra* note 45, ¶ 502.03[7][f].

⁶² See 11 U.S.C. § 502(b).

⁶³ COLLIER, *supra* note 45, ¶ 502.03[7][f].

⁶⁴ See, e.g., *Kopolow v. P.M. Holding Corp. (In re Modern Textiles, Inc.)*, 900 F.2d 1184, 1191 (8th Cir. 1990) (“[T]he liability of a guarantor for a debtor’s lease obligations is not altered by the Trustee’s rejection of the lease.”).

⁶⁵ 11 U.S.C. § 524(e) (“[D]ischarge of a debt of the debtor does not affect the liability of any other entity on . . . such debt.”).

⁶⁶ See *In re Farley, Inc.*, 146 B.R. 739, 740 (Bankr. N.D. Ill. 1992).

⁶⁷ See *id.*

⁶⁸ See 11 U.S.C. § 502(b)(6).

⁶⁹ See, e.g., *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 918 (2d Cir. 1944).

⁷⁰ *Id.*

landlord is not “permitted to offset his actual damages against his security deposit and then claim the balance under [the Cap].”⁷¹

The *maximum* a landlord can recover for prospective rent loss is the Cap amount.⁷² If the cash security deposit is greater than this amount, the excess must be returned to the debtor’s estate,⁷³ as would any other estate property held by an over-secured creditor.⁷⁴ If the cash security deposit is less than the maximum amount, the claim is bifurcated into a secured portion and an unsecured portion.⁷⁵

The *Oldden* dissent argued Congress did not intend the Cap⁷⁶ to deprive the landlord of the ability to bargain with a tenant of questionable financial stability to whom he would not otherwise lease his property.⁷⁷ Justice Frank questioned whether Congress intended the one year maximum to operate against a landlord’s secured claim and would have held the Cap only applied to the landlord’s unsecured claim.⁷⁸ Nonetheless, the subsequent legislative history expressed approval of the majority holding in *Oldden*.⁷⁹

D. Letters of Credit

The three parties to a letter of credit⁸⁰ have distinct duties to each other.⁸¹ The obligations between tenant and landlord flow from their lease agreement.⁸²

⁷¹ H.R. REP. NO. 95-595, at 353-54 (1974), as reprinted in 1978 U.S.C.C.A.N. 5963, 6309. Take for example the situation in which a landlord holds a state law claim for \$1 million (a claim for all future rent through the end of the lease), a capped claim of \$100,000, and a cash security deposit of \$50,000. The landlord would argue the \$50,000 security deposit should be applied against his *state law* claim of \$1 million, thereby reducing his gross claim to \$950,000. See, e.g., *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 208 (3d Cir. 2003). The gross claim (\$950,000) would be compared to the Cap (\$100,000), and the landlord would have a claim for \$100,000 plus he would also keep the \$50,000 deposit. See *id.* In codifying the *Oldden* decision, however, Congress intended the security deposit to be applied to the capped claim, leaving the landlord with \$50,000 in cash and a claim for \$50,000 (\$100,000 capped claim minus \$50,000 security deposit). See *id.*

⁷² See *Oldden*, 143 F.2d at 921.

⁷³ See *id.*

⁷⁴ See 11 U.S.C. § 506(a) (2000).

⁷⁵ H.R. REP. NO. 95-595, at 353, as reprinted in 1978 U.S.C.C.A.N., at 6309.

⁷⁶ In *Oldden*, the cap at issue was the cap under the 1934 Amendment, not the Cap under 11 U.S.C. § 502(b)(6). However, because the Cap was a codification of *Oldden*, for analytical purposes the two are indistinguishable. See H.R. REP. NO. 95-595, at 353-54, as reprinted in 1978 U.S.C.C.A.N., at 6309.

⁷⁷ 143 F.2d at 922 (Frank, J., dissenting).

⁷⁸ *Id.*

⁷⁹ H.R. REP. NO. 95-595, at 353-54, as reprinted in 1978 U.S.C.C.A.N., at 6309.

⁸⁰ The issuer/bank, the applicant/tenant, and the beneficiary/landlord. See MCCULLOUGH, *supra* note 8, § 2.05(1).

⁸¹ Winick, *supra* note 13, at 738-40.

The bank's obligation to the landlord, however, is independent from any obligation between the landlord and tenant.⁸³ If the landlord complies with the conditions set forth in the letter of credit, usually a tender of pre-agreed documentation,⁸⁴ the bank is obligated to pay the landlord.⁸⁵ Moreover, any disputes between the landlord and the tenant do not effect the bank's obligation to pay the landlord.⁸⁶ Even if the landlord improperly draws on the letter of credit,⁸⁷ the bank is still obligated to pay the landlord.⁸⁸ Although the tenant may have an independent cause of action against the landlord, the tenant has no cause of action against the bank.⁸⁹ Finally, the tenant's obligation to the bank—to pay for the letter of credit and reimburse the bank upon the landlord's draw on the letter—is controlled entirely by the contract between these two parties, typically in the form of a reimbursement agreement.⁹⁰

The interplay of the three contracts (the letter of credit contract between the tenant and the bank, the letter of credit issued by the bank to the landlord, and the lease between the tenant and landlord) is known as the "Independence Principle"⁹¹ and is the cornerstone of the law of letters of credit.⁹² The most important consequence of the Independence Principle is neither the letter of credit, nor its proceeds, become property of the tenant's bankruptcy estate.⁹³ The letter of credit and its proceeds are property of the issuing bank.⁹⁴ This is unlike a cash security deposit, which is deemed to be the tenant's property and *does* become property of the estate upon the tenant's filing for bankruptcy.⁹⁵

⁸² See MCCULLOUGH, *supra* note 8, § 2.05(1).

⁸³ Kellogg v. Blue Quail Energy, Inc. (*In re Compton Corp.*), 831 F.2d 586, 590 (5th Cir. 1987); *see also* Guy C. Long, Inc. v. Dependable Ins. Co. (*In re Guy C. Long, Inc.*), 74 B.R. 939, 943 (Bankr. E.D. Pa. 1987) (stating relationship between bank and beneficiary is independent of any other agreements).

⁸⁴ MCCULLOUGH, *supra* note 8, § (II).

⁸⁵ *In re Compton Corp.*, 831 F.2d at 590.

⁸⁶ *Id.*

⁸⁷ This might occur by the landlord delivering an affidavit of default when the tenant is not actually in default.

⁸⁸ MCCULLOUGH, *supra* note 8, § 2.05(1).

⁸⁹ *Id.* In such action, it will be the letter of credit contract, and not the Bankruptcy Code, which determines the amount of damages—i.e., neither the Cap nor any other provision of the Bankruptcy Code applies to limit the tenant's claim against the landlord. *See* Gasel Transp. Lines, Inc. v. Gen. Sec. Ins. Co., No. 00CA30, 2001 Ohio App. LEXIS 1527, at *13–14 (Ohio Ct. App. Mar. 23, 2001).

⁹⁰ See MCCULLOUGH, *supra* note 8, § 3.03.

⁹¹ U.C.C. § 5-103; 5-103(d) (2002).

⁹² Winick, *supra* note 13, at 738.

⁹³ *See, e.g.*, Kellogg v. Blue Quail Energy, Inc. (*In re Compton Corp.*), 831 F.2d 586, 589 (5th Cir. 1987) (holding the automatic stay does not prohibit a lender from drawing upon a letter of credit because the lender is receiving property of the issuer, not property of the debtor's estate).

⁹⁴ *Id.*

⁹⁵ Winick, *supra* note 13, at 738.

The fundamental purpose of a letter of credit is to shift the risk of non-payment from the landlord to the issuing bank.⁹⁶ This allows the landlord to “rely on assured, prompt payment from a solvent party.”⁹⁷ In this limited respect, a letter of credit is similar to a third party guaranty.⁹⁸ A letter of credit is the bank’s obligation, not the debtor’s, and thus the argument is a letter of credit is analogous to and should be treated similar to a guaranty.⁹⁹ This is an important analogy because guaranties are *not* subject to the Cap on a landlord’s damages.¹⁰⁰ Therefore, proponents of this theory argue a letter of credit is also not subject to the bankruptcy limitation.¹⁰¹ However, while a letter of credit is similar to a guaranty, it is not identical.

There are a number of fundamental differences between a letter of credit and a guaranty.¹⁰² First, and most importantly, as implied by the Independence Principle, the issuer of a letter of credit has an independent duty to perform notwithstanding perfect performance of the customer or beneficiary.¹⁰³ Second, the obligation of a guarantor is secondary (contingent on default by the guarantee) while the obligation of an issuer is primary (based on the issuer’s own letter of credit contract with the beneficiary and *not* contingent on default by the applicant).¹⁰⁴ Third, the guarantor can raise defenses that the principal has against the creditor, but an issuer may not assert the customer’s defenses against the beneficiary.¹⁰⁵ Finally, the obligation of a guarantor cannot mature unless the principal has actually defaulted, while an issuer’s obligation arises upon compliance with the terms of the letter of credit, which may or may not include default by the customer.¹⁰⁶ These inherent differences between the two instruments are at the heart of the opposition to according them equal treatment. Some commentators believe that whether a letter of

⁹⁶ See MCCULLOUGH, *supra* note 8, § (II)(B).

⁹⁷ San Diego Gas & Electric Co. v. Bank Leumi, 50 Cal. Rptr. 2d 20, 24 (Cal. Ct. App. 1996).

⁹⁸ See MCCULLOUGH, *supra* note 8, § (II)(B).

⁹⁹ See *supra* text accompanying notes 45–48.

¹⁰⁰ See *supra* text accompanying notes 45–48.

¹⁰¹ See St. James, *supra* note 3, at 320–21.

¹⁰² Berliner Handels-Und Frankfurter Bank v. E. Tex. Steel Facilities, Inc. (*In re E. Tex. Steel Facilities, Inc.*), 117 B.R. 235, 241 (Bankr. N.D. Tex. 1990).

¹⁰³ *Id.*

¹⁰⁴ *Id.* This may not be necessary to the distinction between the two instruments. At least one jurist believes the “former objection that letters of credit are primary, not secondary, obligations was obliterated by the adoption of U.C.C. § 5-117(a) in the 1995 version of Article 5.” Redback Networks, Inc. v. Mayan Networks Corp. (*In re Mayan Networks Corp.*), 306 B.R. 295, 310 (B.A.P. 9th Cir. 2004) (Klein, J., concurring).

¹⁰⁵ *In re E. Tex. Steel Facilities, Inc.*, 117 B.R. at 241.

¹⁰⁶ *Id.*

credit is treated like a cash security deposit or a guaranty creates disparate results with regard to a landlord's rights under the Cap.¹⁰⁷ As such, the distinction has been the subject of much debate.¹⁰⁸ Just a few years ago, commentators were advocating landlords use letters of credit to circumvent the Cap because they believed courts may treat them like a guaranty.¹⁰⁹ Recent case law, however, has shed doubt on both the viability of letters of credit for this purpose and the importance of distinguishing letters of credit from guaranties in resolving landlord-tenant bankruptcy issues.¹¹⁰

II. STATE OF THE LAW TODAY

Before the Fifth Circuit's decision in *In re Stonebridge*, there were three seminal cases that analyzed letters of credit in the context of the Cap; all three were decided within the past four years and all resulted in holdings that favored the tenant/estate.¹¹¹ The first, *In re PPI Enterprises, Inc.*,¹¹² and the third, *In re Mayan Networks Corp.*,¹¹³ involved the common scenario in which the security deposit was less than the Cap. The second case, *In re Stonebridge Technologies, Inc.*,¹¹⁴ the district court case that was directly overruled by the Fifth Circuit,¹¹⁵ appears to be the only case to have addressed the issue where the security deposit was in excess of the Cap. A fourth case, *Musika v. Arbutus Shopping Ctr. Ltd. P'ship (In re Farm Fresh Supermarkets of Maryland)*,¹¹⁶ is not a Cap case, but it is relevant to the analysis of letters of credit. This section will discuss these four cases in chronological order, followed by a detailed analysis of the Fifth Circuit's *In re Stonebridge* decision and, finally, an attempt to reconcile all five cases.¹¹⁷

¹⁰⁷ See, e.g., *St. James*, *supra* note 3, at 321.

¹⁰⁸ See, e.g., *id.*

¹⁰⁹ See, e.g., Geoffrey L. Berman et al., *Landlords Use Letters of Credit to Bypass the Claim Cap of § 502(b)(6)*, 20 AM. BANKR. INST. J. 16, 16 (2002); Winick, *supra* note 13, at 764.

¹¹⁰ See discussion *infra* Part II.A-D.

¹¹¹ See *infra* Part II.B-D.

¹¹² 324 F.3d 197, 207 (3d Cir. 2003).

¹¹³ 306 B.R. 295, 297 (B.A.P. 9th Cir. 2004).

¹¹⁴ *Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (In re Stonebridge Techs., Inc.)*, 291 B.R. 63 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

¹¹⁵ *EOP-Colonnade of Dallas, Ltd. P'ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 271 (5th Cir. 2005).

¹¹⁶ *Musika v. Arbutus Shopping Ctr. Ltd. P'ship (In re Farm Fresh Supermarkets of Md., Inc.)*, 257 B.R. 770 (Bankr. D. Md. 2001).

¹¹⁷ It is worthwhile to note that while some of these cases have stressed the importance of the reimbursement agreement between the tenant and the bank, and some have omitted it as a relevant factor, for purposes of this Comment, a discussion of the reimbursement agreement will be omitted. There are three

A. In re Farm Fresh Supermarkets of Md., Inc.

In *Farm Fresh*, the tenant obtained for its landlord a letter of credit in the amount of \$38,000.¹¹⁸ On the date of the tenant's involuntary chapter 7 filing, the landlord notified the tenant it was in default under the lease because the current month's rent check, approximately \$13,000, was returned for insufficient funds.¹¹⁹ The tenant gave the landlord notice that the letter of credit was property of the bankruptcy estate and a draw on it would constitute a violation of the automatic stay.¹²⁰ Nonetheless, the landlord drew down the entire \$38,000.¹²¹

The chapter 7 trustee made a motion to assume and assign the lease.¹²² As required by the Bankruptcy Code,¹²³ the trustee paid the landlord \$13,000 to cure the rent default.¹²⁴ This payment was made despite the fact that the landlord had already drawn the entire letter of credit.¹²⁵ Nearly one year later, the trustee filed suit against the landlord seeking recovery of the \$13,000 rent payment as property of the estate, and the return of the \$38,000 under a claim of unjust enrichment.¹²⁶

The court held the trustee could not recover and offered two explanations for its holding.¹²⁷ First, when the trustee assumed and assigned the lease, all rights and obligations that came with the lease, previously held by the estate,

possible combinations of the reimbursement agreement, letter of credit, and Cap that would be germane to this discussion. First, the reimbursement agreement could be greater than or equal to the letter of credit (Ex: Cap 100, letter of credit 200, collateral supporting reimbursement agreement 200). Second, the reimbursement agreement could be less than the letter of credit but greater than or equal to the Cap, such as Cap 100, letter of credit 200, and collateral 150. Third, the reimbursement agreement could be less than the Cap, such as Cap 100, letter of credit 200, and collateral 50. For purposes of this Comment, the differences can be ignored because in all cases there will never be a claim, secured or unsecured, against the estate for an amount greater than the letter of credit. Also ignored will be the argument that the estate is only liable for the Cap and the issuer is liable for the full amount of the letter of credit. In these respects, this Comment is consistent in its analysis regardless of either (1) the amount of the reimbursement agreement, or (2) whom is ultimately liable (tenant or bank) for the letter of credit proceeds in excess of the Cap.

¹¹⁸ 257 B.R. at 771.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ See 11 U.S.C. § 365(b)(1)(A) (2000).

¹²⁴ *In re Farm Fresh Supermarkets of Md., Inc.*, 257 B.R. at 771.

¹²⁵ *Id.*

¹²⁶ *Id.* at 771–72.

¹²⁷ *Id.* at 772.

were now extinguished and presumably held by the assignee.¹²⁸ Accordingly, the trustee no longer had standing to recover the amounts paid by the estate to cure the default or the amount paid to the landlord under the letter of credit.¹²⁹ Second, the court took the position that a letter of credit is analogous to a guarantee.¹³⁰ Like a guarantee, a letter of credit gives the landlord “the right to obtain payment from a third party for which the debtor may ultimately be liable, but which the trustee cannot recover.”¹³¹ Most importantly, the court held neither the letter of credit nor its proceeds were property of a debtor’s estate.¹³² Therefore, the automatic stay did not bar the landlord from drawing on the letter, and because the proceeds were not property of the estate, the draw did not constitute an avoidable postpetition transfer.¹³³

B. *In re PPI Enterprises, Inc.*

In re PPI Enterprises, Inc. appears to be the first case to analyze the relationship between a letter of credit and the Bankruptcy Code’s limitation on a landlord’s claim.¹³⁴ It dealt with the common situation in which the proceeds from the letter of credit were less than the allowable claim for damages under the Cap.¹³⁵ The landlord argued proceeds from the letter of credit should reduce his applicable state law damages *in excess* of the Cap¹³⁶ on the grounds the payment of such damages was by a third party, not by the estate, and therefore outside the scope of the Cap.¹³⁷ The tenant, not surprisingly, argued any payments under the letter of credit should be included within the maximum recovery permitted under the Cap.¹³⁸

The bankruptcy court held, and the Third Circuit affirmed, payments under the letter of credit on these facts should be treated the same as a cash security deposit and applied toward the maximum recovery under the Cap.¹³⁹ The

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 200 (3d Cir. 2003).

¹³⁵ Key facts were omitted from the decision, including whether the debtor or someone else funded the letter of credit and whether the lease provided the security deposit would be refunded to the debtor following performance of the lease. *See id.*

¹³⁶ *See supra* note 71.

¹³⁷ *In re PPI Enters., Inc.*, 324 F.3d at 209.

¹³⁸ *Id.*

¹³⁹ *Id.*

Third Circuit based its decision primarily on the lease provision that stated, “[i]n lieu of the cash security provided. . . . Tenant may deliver to landlord . . . as security . . . an irrevocable, clean, commercial, letter of credit”¹⁴⁰

Some commentators have argued when a letter of credit is “in lieu” of a cash security deposit, as opposed to an *actual* cash security deposit, the Cap should not apply.¹⁴¹ In *In re PPI Enterprises, Inc.*, however, the Third Circuit interpreted this language to reflect the parties’ intent that the letter of credit operate as a cash security deposit, and thus viewed the distinction between a third party letter of credit and a cash security deposit, on these facts, as purely technical.¹⁴² In doing so, the Third Circuit relied on *Oldden*.¹⁴³ The fact that *Oldden* involved a cash security deposit given directly to the landlord by the tenant, and in the instant case, it had been provided by a third party was “insufficient to justify divergent rules.”¹⁴⁴

The Third Circuit recognized the Independence Principle of letters of credit, citing *Farm Fresh*.¹⁴⁵ Based solely on the principle that a letter of credit is not part of the debtors’ estate and the apparent inapplicability of the Cap to a tenant’s guarantor,¹⁴⁶ the court would have had difficulty in justifying its holding. To remedy that obstacle, the court fashioned an alternate view. It recognized what really happens following the landlord’s draw on a letter of credit is the tenant becomes liable to the bank for the same amount.¹⁴⁷ The result was an “end run around § 502(b)(6)” with the landlord receiving a windfall at the other creditors’ expense.¹⁴⁸ The equitable approach, then, would be to treat the letter of credit as a *payment* to the landlord, thus reducing the debtor’s burden under the Cap.¹⁴⁹ Because the court chose to rely on the language of the lease for its holding, however, it explicitly left unanswered whether a letter of credit is generally part of the debtor’s estate and whether the Independence Principle or the “payment” theory should govern.¹⁵⁰

¹⁴⁰ *Id.* at 210.

¹⁴¹ See Winick, *supra* note 13, at 752.

¹⁴² *In re PPI Enters., Inc.*, 324 F.3d at 210.

¹⁴³ *Id.*; see *supra* notes 68–75 and accompanying text.

¹⁴⁴ *In re PPI Enters., Inc.*, 324 F.3d at 210; see *supra* notes 68–75 and accompanying text.

¹⁴⁵ *In re PPI Enters., Inc.*, 324 F.3d at 209.

¹⁴⁶ See *supra* text accompanying notes 45–48.

¹⁴⁷ *In re PPI Enters., Inc.*, 324 F.3d at 209.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ “[W]e need not decide the underlying question because it is clear that the parties intended the letter of credit to operate as a security deposit.” *Id.* at 210.

C. *In re Stonebridge Technologies, Inc.—The District Court Decision*

Stonebridge is the only case that addresses the factual scenario underlying the thesis of this Comment: the letter of credit proceeds being greater than the landlord's claim under the bankruptcy limitation.¹⁵¹ In *Stonebridge*, the lease provided, under the provision titled "Security Deposit," that "a portion of the Security Deposit may be in the form of an irrevocable letter of credit."¹⁵² The landlord argued the Independence Principle mandates a letter of credit can never constitute a security deposit and, as such, he was entitled to keep the full amount of the letter of credit.¹⁵³ The bankruptcy trustee, on the other hand, argued the Bankruptcy Code mandates letter of credit proceeds above the Cap is returned to the estate.¹⁵⁴

The bankruptcy court ruled in favor of the trustee and ordered the landlord to return the letter of credit proceeds in excess of the Cap.¹⁵⁵ In explaining its holding, the court noted *In re PPI Enterprises, Inc.* did not consider whether a letter of credit inherently consists of a security deposit, but rather the court's ruling was based on the terms of the lease that said the letter of credit was "in lieu of a cash security deposit."¹⁵⁶ Under that analysis, the instant case was made one-step easier because the parties expressly contracted that the letter of credit be part of the security deposit.¹⁵⁷ Therefore, the letter of credit, on these facts, constituted a security deposit for purposes of the Cap, and once again, it was not necessary for the court to determine whether letters of credit are inherently analogous to guaranties.¹⁵⁸

As in *In re PPI Enterprises, Inc.*, the *Stonebridge* court recognized the Independence Principle.¹⁵⁹ Unlike the Third Circuit, however, the Texas bankruptcy court expressly noted "the law in this Circuit is clear," a letter of credit and its proceeds are not property of the estate.¹⁶⁰ Given the *Stonebridge* court's conviction regarding the clarity of the Independence Principle, it is puzzling how it reached the holding. In what appears to be an example of

¹⁵¹ Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (*In re Stonebridge Techs., Inc.*), 291 B.R. 63, 67 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

¹⁵² *Id.* at 65.

¹⁵³ *Id.* at 69.

¹⁵⁴ *Id.* at 67–68.

¹⁵⁵ *Id.* at 70–71.

¹⁵⁶ *Id.* at 69.

¹⁵⁷ *Id.* at 65.

¹⁵⁸ *Id.* at 70.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

start-with-the-result-first jurisprudence, the court developed an artificial construct by holding the Independence Principle only protects the *distribution* of the proceeds of the letter of credit.¹⁶¹ In other words, the landlord is not prohibited by the automatic stay from drawing down on the letter of credit;¹⁶² the Independence Principle, however, does not govern how the proceeds are to be *applied*.¹⁶³ Thus, the *Stonebridge* court relied entirely on the language of the lease to conclude the lease and bankruptcy law, and not the Independence Principle, control the *application* of the proceeds.¹⁶⁴

Although the court went to great lengths to explain its characterization of the Independence Principle and to address whether a letter of credit can be a security deposit, this discussion may have been unnecessary.¹⁶⁵ The Independence Principle usually mandates a letter of credit and its proceeds are not property of the estate.¹⁶⁶ The landlord in *Stonebridge*, however, breached the lease by improperly drawing on the letter of credit.¹⁶⁷ Upon breach by the landlord, the Independence Principle was functionally nullified because the estate now has a claim against the landlord for the improper draw on the letter of credit.¹⁶⁸ The landlord would possibly be subject to “disgorgement of the . . . proceeds in full.”¹⁶⁹ The landlord would have been required to assert a claim against the lessee if he wished to obtain any recovery.¹⁷⁰ This claim would have been subject to the Cap.¹⁷¹ It appears the court chose to avoid these procedural steps and jumped directly to requiring the landlord to turn over the letter of credit proceeds in excess of the Cap.¹⁷²

In support of this theory, the *Stonebridge* court chose to quote the legislative history,¹⁷³ but conspicuously omitted the one passage most factually relevant to the case: “[T]o the extent that a landlord has a security deposit in

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.* at 70.

¹⁶⁴ *See id.* at 71.

¹⁶⁵ *See* Laura B. Bartell, *The Lease Cap and Letters of Credit: A Reply to Professor Dolan*, 120 BANKING L.J. 828, 840 n.23 (2003).

¹⁶⁶ *See, e.g.,* Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 589 (5th Cir. 1987).

¹⁶⁷ *In re Stonebridge Techs., Inc.*, 291 B.R. at 72.

¹⁶⁸ *See* Bartell, *supra* note 165, at 833 n.23.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ Faulkner v. EOP-Colonnade of Dallas, Ltd. P’ship (*In re* Stonebridge Techs., Inc.), 291 B.R. 63, 69–70 (Bankr. N.D. Tex. 2003), *rev’d*, 430 F.3d 260 (5th Cir. 2005).

excess of the amount of his claim allowed under this paragraph, the excess comes into the estate.”¹⁷⁴ The court determined the letter of credit at issue constituted a security deposit.¹⁷⁵ The letter of credit proceeds were greater than the Cap.¹⁷⁶ It is confusing, then, why the court did not conclude its opinion with the preceding quote.¹⁷⁷ Instead, the court distinguished *Stonebridge* from *Farm Fresh*, based on the landlord’s breach of the lease.¹⁷⁸ Perhaps, had the landlord not breached the lease, *Stonebridge* would have held, like *Farm Fresh*,¹⁷⁹ that the letter of credit proceeds were not recoverable because they were not property of the estate.¹⁸⁰ At the very least, this begs the question whether the distinction between the distribution and application of letter of credit proceeds is anything more than fact specific dicta that subsequent courts, faced with a letter of credit in excess of the Cap, are free to ignore.

D. In re Mayan Networks Corp.

In *Mayan*, as in *In re PPI Enterprises, Inc.*,¹⁸¹ the proceeds from the letter of credit were less than the maximum allowed claim and the landlord wanted to apply the proceeds to the total non-bankruptcy damages before application of the Cap.¹⁸² The lease in *Mayan* required a \$1 million security deposit as “security for the faithful performance [by tenant] of all of [tenant’s] obligations”¹⁸³ The tenant posted approximately \$350,000 in cash and a letter of credit for \$650,000.¹⁸⁴ The lease required the unused balance of the security deposit be returned to the tenant at the end of the lease term.¹⁸⁵ The tenant pledged cash deposits in excess of \$650,000 to the issuing bank to secure the letter of credit.¹⁸⁶

¹⁷⁴ H.R. REP. NO. 95-595, at 353–54, as reprinted in 1978 U.S.C.C.A.N. 5963, 6309.

¹⁷⁵ *In re Stonebridge Techs., Inc.*, 291 B.R. at 69–70.

¹⁷⁶ *Id.* at 67.

¹⁷⁷ See *supra* note 174 and accompanying text.

¹⁷⁸ 291 B.R. at 71–72.

¹⁷⁹ *Masika v. Arbutus Shopping Ctr., Ltd. P’ship (In re Farm Fresh Supermarkets of Md., Inc.)*, 257 B.R. 770, 772 (Bankr. D. Md. 2001).

¹⁸⁰ See *id.*

¹⁸¹ *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 209 (3d Cir. 2003).

¹⁸² *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 297 (B.A.P. 9th Cir. 2004).

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

The Bankruptcy Appellate Panel for the Ninth Circuit held the letter of credit proceeds should be applied against the allowed claim under the Cap, thereby reducing the landlord's general unsecured claim against the bankruptcy estate.¹⁸⁷ Although the Cap is silent on the treatment of a security deposit,¹⁸⁸ the court relied upon legislative history, which said the purpose of the Cap was to "compensate the landlord for his loss while not permitting a claim so large . . . as to prevent other general unsecured creditors from recovering a dividend of the estate."¹⁸⁹ From this the panel reasoned the function of the Cap is not to limit a landlord's recovery, but rather to limit the estate's liability.¹⁹⁰ The questions left to the panel were whether the letter of credit should be treated like a security deposit and what effect it had on the estate.¹⁹¹

The *Mayan* court, like *Farm Fresh*¹⁹² and *Stonebridge*,¹⁹³ recognized the Independence Principle and acknowledged neither the letter of credit nor its proceeds are property of the estate.¹⁹⁴ The panel announced the Independence Principle is a "red herring," however, because there is nothing in the statute or legislative history that says the Cap applies only to amounts paid directly from property of the estate.¹⁹⁵ "Rather, the appropriate analysis looks to the impact that the draw upon the letter of credit has on the property of the estate."¹⁹⁶ The cash deposits pledged to the bank to secure the letter of credit were property of the estate, and were used, in effect, to pay the landlord.¹⁹⁷ Therefore, the panel explained, this is not a true third party obligor situation because the bank was fully protected if it had to pay on the letter of credit.¹⁹⁸

In concluding the letter of credit has the same effect as a cash security deposit, the majority applied the *Oldden* rationale to anything that is equivalent to a security deposit.¹⁹⁹ In doing so, the court defined a security deposit as

¹⁸⁷ *Id.* The landlord's capped claim was for \$2.05 million. *Id.* The \$350,000 cash security deposit, which the landlord kept, reduced the claim to \$1.7 million. *Id.* The landlord argued the \$650,000 drawn on the letter of credit should not further reduce his claim, but the court held it did, leaving the landlord with a claim for \$1.05 million. *Id.*

¹⁸⁸ 11 U.S.C. § 502(b)(6) (2000).

¹⁸⁹ *In re Mayan Networks, Inc.*, 306 B.R. at 298.

¹⁹⁰ *Id.* at 299.

¹⁹¹ *Id.*

¹⁹² *See supra* note 132.

¹⁹³ *See supra* note 160.

¹⁹⁴ *In re Mayan Networks, Inc.*, 306 B.R. at 299.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at 300.

¹⁹⁹ *Id.* at 301.

“not limited to cash only. If the collateral would come back to the Debtor, but for the existence of the pledge of security, then it is a security deposit for the purpose of this analysis.”²⁰⁰

Concurring in the *Mayan* decision, Judge Klein offered two criticisms of the majority opinion’s reliance on *In re PPI Enterprises, Inc.* First, the *In re PPI Enterprises, Inc.* court reasoned incorrectly the Cap limits the landlord’s remedies rather than limiting the estate’s liability.²⁰¹ The Bankruptcy Code’s interrelated provisions regarding disallowance, subrogation, turnover, and setoff make it clear the estate cannot be liable for more than the Cap.²⁰² Second, *In re PPI Enterprises, Inc.* incorrectly relied on *Oldden* and the legislative history as precedent because an examination of the provisions of the Bankruptcy Code leads to the same result as *Oldden*.²⁰³ Judge Klein cautioned the *Oldden* rationale could be applied too broadly if it credited a true third-party security deposit against the Cap, which would result in a windfall to the estate.²⁰⁴

Sensing the contradictions between the Third Circuit’s *In re PPI Enterprises, Inc.* and the Ninth Circuit’s *Mayan* opinions, Judge Klein recognized the current state of landlord/tenant bankruptcy law is inconsistent and called for an approach to stabilize it.

In light of these principles, we should be articulating a rational analysis for deciding this and future appeals because the upshot of this state of the law is an inexorable desire by well-advised landlords entering into long-term leases . . . to devise credit enhancements that will not be defeated by bankruptcy. Congress, in effect, has blessed such strategies . . . which [lead] parties to address bankruptcy risk by requiring creditworthy co-obligors or insisting that security deposits come from sources, and with refund obligations, that are not property of the estate. Under the terms of the Bankruptcy Code, such strategies are viable.²⁰⁵

²⁰⁰ *Id.*

²⁰¹ *Id.* at 311 (Klein, J., concurring).

²⁰² *Id.* at 302.

²⁰³ *Id.* at 311.

²⁰⁴ *Id.* at 310–13.

²⁰⁵ *Id.* at 307.

E. The Fifth Circuit's In re Stonebridge Technologies, Inc. Decision—The First Step in the Landlords Direction

In November of 2005, the Fifth Circuit overruled the decision of the district court in *Stonebridge* and, for the first time, a court handed down a landlord friendly ruling.²⁰⁶ *Stonebridge*, as described above,²⁰⁷ was the only case to involve a letter of credit with proceeds in excess of the Cap.²⁰⁸ Rather than crafting a rule using the analytical underpinnings of the Cap,²⁰⁹ *Oldden*,²¹⁰ *Farm Fresh*,²¹¹ *In re PPI Enterprises, Inc.*,²¹² *Mayan*,²¹³ or even the analysis by the *Stonebridge* district court,²¹⁴ the Fifth Circuit based its holding on form over substance.²¹⁵ The court reasoned that because the landlord never filed a claim for future rent damages, the Cap did not apply; the landlord was entitled to retain the entire proceeds from the letter of credit.²¹⁶ Although this opinion addressed the Independence Principle of letters of credit, it is somewhat unique in that it omits any discussion of the effect on the estate, legislative history, or Congressional intent.

This is the decision landlords have been waiting for—a pure plain reading of the applicable statute. The purpose of the Cap is to limit a claim;²¹⁷ if no claim is filed, the Cap does not apply, end of story.²¹⁸ Assuming this decision is not appealed to the Supreme Court and is adopted by other courts, landlords holding letters of credit may never again (nor should they) file a claim for breach of lease damages. The *Stonebridge* district court did not allow the landlord to retain the entire letter of credit for a number of reasons,²¹⁹ primary among them was an artificial construct distinguishing the *distribution* of letter

²⁰⁶ See EOP-Colonnade of Dallas, Ltd. P'ship v. Faulkner (*In re Stonebridge Techs., Inc.*), 430 F.3d 260, 271 (5th Cir. 2005).

²⁰⁷ See *supra* Part IIC.

²⁰⁸ Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (*In re Stonebridge Techs., Inc.*), 291 B.R. 63, 67 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

²⁰⁹ See *supra* Part IA.

²¹⁰ See *supra* Part IA.

²¹¹ See *supra* Part IIA.

²¹² See *supra* Part IIB.

²¹³ See *supra* Part IID.

²¹⁴ See *supra* Part IIC.

²¹⁵ See EOP-Colonnade of Dallas, Ltd. P'ship v. Faulkner (*In re Stonebridge Techs., Inc.*), 430 F.3d 260, 371 (5th Cir. 2005).

²¹⁶ *Id.* at 271.

²¹⁷ See 11 U.S.C. § 502(b) (2000).

²¹⁸ *In re Stonebridge Techs., Inc.*, 430 F.3d at 271.

²¹⁹ See *supra* notes 161–64.

of credit proceeds from the *application* of those proceeds.²²⁰ The Fifth Circuit, however, expressly stated that because the landlord never filed a claim, any mechanical differences between drawing and retaining funds from a letter of credit are irrelevant.²²¹

The Fifth Circuit noted, however, that had the landlord filed a claim against the estate, it would have been limited to the Cap.²²² The parties' concession on that point²²³ relieved the court from truly grappling with the hard issue, which is the subject matter of this Comment. Thus, we now have bad dicta²²⁴ on top of holdings premised upon questionable legal analyses.²²⁵ The Fifth Circuit's "don't file a claim" ruling may discourage landlords from ever litigating this issue again.²²⁶ This should not, however, discourage legal scholars from offering cogent analyses for those courts that may need to address the real issue at hand—whether allowing a landlord to keep letter of credit proceeds in excess of the Cap is consistent with Congressional bankruptcy policy, irrespective of whether a landlord elects to file a claim against the bankruptcy estate.

F. Conflict and Accord Within the Law

The foregoing cases do not prohibit a landlord from drawing down on a letter of credit, nor do they suggest the proceeds from a letter of credit will *always* be applied to the Cap.

In re PPI Enterprises, Inc. and the *Stonebridge* district court cases were decided within a week of each other, and each court crafted its own novel solution to the conflict between the Cap and the Independence Principle. Although in dicta, *In re PPI Enterprises, Inc.* dismissed the Independence Principle in the name of equity,²²⁷ while *Stonebridge* distinguished between the distribution and application of the letter of credit proceeds.²²⁸ Because the *Stonebridge* district court perceived an improper draw on the letter of credit, however, its circumvention of the Independence Principle may also have been

²²⁰ See *supra* notes 161–64.

²²¹ *In re Stonebridge Techs., Inc.*, 430 F.3d at 268 n.5.

²²² *Id.* at 270 n.9.

²²³ *Id.*

²²⁴ See *id.*

²²⁵ See Part II.A-D.

²²⁶ See *In re Stonebridge Techs., Inc.*, 430 F.3d at 271.

²²⁷ See *Solow v. PPI Enters., Inc.* (*In re PPI Enters., Inc.*), 324 F.3d 197, 209 (3d Cir. 2003).

²²⁸ See *Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship* (*In re Stonebridge Techs., Inc.*), 291 B.R. 63, 69–70 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

mere dicta.²²⁹ Ultimately, both cases relied upon the language of the lease to hold the letter of credit should be treated like a security deposit.²³⁰ Therefore, it is unclear what impact, if any, these decisions have on the Independence Principle.

Although *In re PPI Enterprises, Inc.* failed to address whether a letter of credit is property of the estate,²³¹ in dicta, the court both attacked the Independence Principle and cited with approval dicta in *Oldden* that implied letters of credit should always be treated like security deposits.²³² *Stonebridge* and *Mayan* distinguished the Independence Principle issues, however, thus shielding it from *In re PPI Enterprises, Inc.*'s attack.²³³ *Mayan*, which also gave deference to the contract provisions, added a new argument by focusing on the effect of the letter of credit on the estate.²³⁴

These decisions have left the state of the law murky at best, but this is the direction courts seem to be heading: when a debtor-tenant has posted a cash security deposit directly, the provisions of the Bankruptcy Code, including but not limited to the Cap and the legislative history thereof, will limit the landlord's rights to recovery of the allowed claim.²³⁵ In this situation, the law is more consistent, better reasoned, and will likely go unchallenged.²³⁶ Where the security has been posted by a third party, such as with a letter of credit, the issue will either be one of contract interpretation²³⁷ or effect on the estate,²³⁸ and the limitations of the Cap arguably may not apply. While the Fifth Circuit may have provided landlords with an easy solution to avoid the application of the Cap,²³⁹ that decision does not obviate the need to develop more consistent and better-reasoned jurisprudence on this issue.

²²⁹ See *id.* at 69–70.

²³⁰ See *supra* notes 156–57.

²³¹ See *supra* text accompanying note 150.

²³² *In re PPI Enters., Inc.*, 324 F.3d at 209.

²³³ See *id.*

²³⁴ *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 299 (B.A.P. 9th Cir. 2003).

²³⁵ See, e.g., *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1994).

²³⁶ See, e.g., *id.*

²³⁷ See, e.g., *In re PPI Enters., Inc.*, 324 F.3d at 210.

²³⁸ See, e.g., *Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (In re Stonebridge Techs., Inc.)*, 291 B.R. 63, 71 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

²³⁹ *EOP-Colonnade of Dallas, Ltd. P'Ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 271 (5th Cir. 2005).

Current decisional law has not undermined the Independence Principle to any significant degree. Landlords will still be able to draw down on letters of credit without violating the automatic stay.²⁴⁰ However, the case law does provide some guidance as to how letter of credit proceeds will be applied, depending on the terms of the lease, and the bona fides of the beneficiary's draw on the letter of credit.²⁴¹ In the absence of a specific ruling from a higher court on the merits or a legislative amendment, however, courts seem determined to find ways to protect the bankruptcy estate at the expense of landlords.²⁴²

III. THE RIGHT TO PROCEEDS IN EXCESS OF THE CAP

Landlords should be entitled to keep letter of credit proceeds in excess of the Cap, even if a claim is filed.²⁴³ The courts, however, have been protecting the bankruptcy estate, stridently espousing creditor equality in support of their holdings.²⁴⁴ Nevertheless, there are many variations of the "letter of credit as security for a lease" scenario,²⁴⁵ and with each one a court needs to tread carefully so as not to trample upon other well-established principles of bankruptcy law and policy.²⁴⁶ In the rare situation in which a landlord holds a letter of credit in excess of the maximum claim, the probability of such trampling becomes dangerously high.²⁴⁷ In this particular situation, two crucial principles should guide the courts in a new direction and compel a definitive rule that proceeds in excess of the Cap should rightfully belong to the landlord. First, a secured landlord should be treated like every other secured creditor.²⁴⁸ Second, letters of credit warrant special treatment, particularly in light of the Congressional policy behind the Cap.²⁴⁹

²⁴⁰ Redback Networks, Inc. v. Mayan Networks Corp. (*In re Mayan Networks Corp.*), 306 B.R. 295, 299 (B.A.P. 9th Cir. 2003).

²⁴¹ *See, e.g., id.*

²⁴² *See, e.g., id.*

²⁴³ After the Fifth Circuit's decision in *Stonebridge*, landlords may never have to file a claim again. *See* 430 F.3d at 271. However, given the *Stonebridge* decision was recently issued and has yet to withstand further judicial scrutiny or be adopted by other circuits, a more in-depth analysis of the issue may be helpful to future courts, particularly those that do not adopt the Fifth Circuit's "plain reading" of the statute.

²⁴⁴ *See, e.g.,* Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (*In re Stonebridge Techs., Inc.*), 291 B.R. 63, 69 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

²⁴⁵ *See supra* note 117.

²⁴⁶ *See supra* Part I.A.

²⁴⁷ *See infra* Part III.B.2.

²⁴⁸ *See* Odden v. Tonto Realty Corp, 143 F.2d 916, 922 (2d Cir. 1994) (Frank, J., dissenting).

²⁴⁹ *See id.*

A. Secured Landlords Versus Secured Creditors

A secured landlord should be treated like every other secured creditor.²⁵⁰ Whether the landlord holds a cash security deposit or a letter of credit, the landlord holds security for the tenant's obligation.²⁵¹ If that security is greater than the Cap, he should be treated like a secured creditor and be allowed to retain the entire amount of his security up to the value of the debt secured.²⁵² The majority in *Oldden*,²⁵³ and the jurists writing the opinions in subsequent cases,²⁵⁴ went to great lengths to distinguish landlords from general unsecured creditors. In the context of a landlord who holds a security deposit less than the Cap, this is a worthy comparison because the landlord does hold an unsecured claim;²⁵⁵ however, that is only one half of a complete analysis. When a landlord holds a security deposit greater than the Cap, courts must treat him as a secured creditor.²⁵⁶

This argument is supported by the *Oldden* dissent, which, compared to the majority, more accurately reflects bankruptcy law and policy.²⁵⁷ A comparison between a landlord and a mortgagee, the other most commonly recognized secured real estate creditor, further elucidates the need to treat them equally. Courts have inferred landlords are to be treated like other secured creditors by holding the landlord is effectively an over-secured creditor when the security deposit is greater than the Cap.²⁵⁸ This reasoning is flawed, however, in that it stops short of according secured landlords the full equality enjoyed by every other secured creditor.²⁵⁹

²⁵⁰ See *id.*

²⁵¹ *Id.*

²⁵² See *id.*

²⁵³ *Id.* at 920.

²⁵⁴ See, e.g., *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 207–08 (3d Cir. 2003).

²⁵⁵ The unsecured claim is the difference between the security deposit and the Cap, assuming the Cap is greater. See *supra* note 18.

²⁵⁶ See *Oldden*, 143 F.2d at 922 (Frank, J., dissenting).

²⁵⁷ See *St. James*, *supra* note 3, at 316–18.

²⁵⁸ See *Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (In re Stonebridge Techs., Inc.)*, 291 B.R. 63, 71 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

²⁵⁹ See *Oldden*, 143 F.2d at 922 (Frank, J., dissenting).

1. *The Oldden Dissent*

The *Oldden* dissent more accurately reflects bankruptcy law and policy. The majority opinion, upon which the current Cap was promulgated, dismisses the priority due to secured creditors.²⁶⁰ The majority stated:

Nor should a landlord obtain an advantage . . . merely because he has been shrewd or economically powerful enough to have obtained a substantial deposit as security . . . landlords would receive different treatment in bankruptcy proceedings, depending upon the existence and size of the security in their possession.²⁶¹

One of the predominant policies of bankruptcy law is “to secure an equitable division of the insolvent debtor’s property among all his creditors.”²⁶² To promote this policy, creditors are divided into classes and each class is accorded different treatment.²⁶³ One such class of creditors is the secured creditor. Holders of secured claims have priority over unsecured creditors—they are entitled to be paid in full up to the value of the collateral securing their claim before unsecured claims are paid at all.²⁶⁴ But the preceding passage from the majority opinion in *Oldden* suggests the court is opposed to, or at the very least has forgotten about, this basic premise of bankruptcy.

Judge Frank, writing the *Oldden* dissent, was considerably more deferential to bankruptcy law and policy:

It is difficult for me to believe that Congress has become so collectivist-minded, so opposed to the common characteristics of our profit system, that it intended that a landlord should not (to quote my colleagues) “obtain an advantage merely because he has been shrewd or economically powerful enough to have obtained a substantial deposit as security” and that landlords should not “receive different treatment . . . depending upon the existence and size of the securities in their possession.” Perhaps it is desirable that by legislation such a leveling should be brought about, that by statute landlords should this be deprived of the benefits of good bargains they have made.²⁶⁵

²⁶⁰ See *id.* at 920.

²⁶¹ *Id.*

²⁶² Louis Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 225 (1918).

²⁶³ See Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 4 (1940) (“[I]n every case the creditors have been assembled in some formal way, their claims examined and classified, and assigned for satisfaction in definite proportions to an existing or prospective fund.”).

²⁶⁴ 11 U.S.C. § 506(a) (2000).

²⁶⁵ *Oldden*, 143 F.2d at 922 (Frank, J., dissenting).

Judge Frank continues by making the poignant argument, which the majority (and the seminal cases discussed above) failed to consider, that a secured landlord should be treated like every other secured creditor.²⁶⁶ He points out neither the wording nor the legislative history of the Cap contain anything to suggest otherwise.²⁶⁷

I see no reason to think that Congress intended that a landlord . . . with respect to [his] security [is] to be treated differently from other secured creditors. . . . Why the fixing of such a maximum should be regarded as amending [the treatment of secured creditors] I cannot understand.²⁶⁸

In support of his position, Judge Frank contends neither Congress nor the Bankruptcy Code intended to limit a landlord's ability to bargain with a tenant of questionable financial stability to whom he would not otherwise lease his property.²⁶⁹ The majority opinion in *Oldden* focused on the *amount* of the security deposit, which the court admitted was mere conjecture,²⁷⁰ and ignored Judge Frank's implication that procuring the lease in the first place is just as important, if not more so.²⁷¹ Indeed, there is every reason to believe a rule that refuses to allow a landlord to keep his entire bargained for security deposit will undermine the freedom of contract between landlord and tenant and simply render tenants of questionable financial stability unable to procure leases.²⁷² This result is antithetical to another one of bankruptcy law's fundamental principles—the encouragement of entrepreneurial activities.²⁷³

Judge Frank's freedom of contract argument is not without support from modern commentators.²⁷⁴ Forcing a landlord to return his security deposit in excess of the Cap sends the message that the contract between the tenant and landlord is "so inherently unworthy that it may not be secured or enforced. . . . [Not unlike] contracts with minors and incompetents, or contracts which have

²⁶⁶ *Id.*

²⁶⁷ *Id.*

²⁶⁸ *Id.*

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷⁰ *Id.* at 921 ("Any question here may be academic . . . we have discovered no reported case where [the security deposit] even approaches the statutory limit . . .").

²⁷¹ *Id.* at 922 (Frank, J., dissenting).

²⁷² *See id.*

²⁷³ *See* JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 1101 (1833) (Bankruptcy law was developed in large part because the previous laws "destroy[ed] all encouragement to industry and enterprise on the part of the unfortunate debtor.").

²⁷⁴ *See* St. James, *supra* note 3, at 317.

an illegal purpose; e.g., prostitution, drugs, violence for hire [wherein] an obligation . . . is held to be inherently unworthy of enforcement.”²⁷⁵ Furthermore, while all of bankruptcy impinges on freedom of contract to some extent, Judge Frank’s position is consistent with the modern Bankruptcy Code’s treatment of the landlord/tenant relationship.²⁷⁶

2. *Landlords Versus Mortgagees*

Both landlords and lenders who undertake investments of considerable sums of money connected with the acquisition or financing of real estate should be entitled to bargain for adequate security to protect their investments in the event of default by their contracting partners (i.e., tenants and borrowers). In both situations, that security is presumptively refundable to the tenant/borrower.²⁷⁷ In a lease, the security deposit, whether held as cash or under a letter of credit, is normally refundable to the tenant upon successful completion of its obligations under the lease.²⁷⁸ Upon successful completion of the borrower’s obligations under a debt instrument secured by a mortgage, the security interest held by the mortgagee and the mortgage is extinguished.²⁷⁹ If there is a default in the latter instance and bankruptcy follows, the mortgagee has a right to adequate protection of the full value of the collateral underlying the mortgagee’s security interest (the property).²⁸⁰ In the lease transaction, the landlord should be treated similarly and should not have to forego the full benefit of his security (the security deposit).²⁸¹ Nonetheless, courts have interpreted the Cap to limit landlords from realizing their bargained-for benefit

²⁷⁵ *Id.*

²⁷⁶ Three relevant sections of the Bankruptcy Code support freedom of contract between commercial landlords and tenants. First, in the event of a landlord’s bankruptcy, the Bankruptcy Code ensures the tenant the benefit of his bargain by providing him the option to either treat the lease as terminated or retain his rights and stay in possession of the property, notwithstanding the landlord’s rejection of the lease. 11 U.S.C. § 365(h)(1)(A)(i)-(ii) (2000). Second, during the limbo period, the tenant-debtor is required to perform all obligations under the lease, including payment of rent at the contract rate. *Id.* § 365(d)(3). The limbo period is the period between the bankruptcy filing and the deadline for the debtor to assume or reject the lease. TABB & BRUBAKER, *supra* note 43, at 334. Finally, the Bankruptcy Code provides assumption or assignment of a shopping center lease by a tenant-debtor is subject to all lease provisions, *id.* § 365(3)(C)-(D), once again carving out an exception that “assure[d] a landlord of his bargained for exchange.” H.R. REP. NO. 95-595, at 354, *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6309.

²⁷⁷ *See Oldden*, 143 F.2d at 918 n.2; GRANT S. NELSON & DALE A. WHITMAN, *CASES AND MATERIALS ON REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT* 506 (6th ed. 2003).

²⁷⁸ *Odden*, 143 F.2d at 918 n.2.

²⁷⁹ NELSON & WHITMAN, *supra* note 277, at 506.

²⁸⁰ *See id.* at 95, 754.

²⁸¹ *See St. James*, *supra* note 3, at 318–19.

by changing the value of the debt owed to them even if the security is provided by a third party.²⁸²

This result is inconsistent with the treatment of mortgagees.²⁸³ In the event of bankruptcy, a mortgagee does not lose his prior negotiated security—bankruptcy law does not second guess the mortgagor's pre-bankruptcy decision to extend a consensual lien on his property and statutorily limit the interest in the property the mortgagee may keep.²⁸⁴ The mortgagee is still entitled to the full amount of its secured debt.²⁸⁵ Even if the property is the debtor's only asset and, as a result of the mortgage, no other creditor is able to recover anything, the mortgagee still realizes on its entire bargained for security.²⁸⁶ Moreover, just as creditor equality is an important policy of bankruptcy law,²⁸⁷ so too is the prioritization of creditors.²⁸⁸ Creditors know the rules of the game.²⁸⁹ If they choose to do business with a debtor who has collateralized all of his assets (be they real property to secure a mortgage or cash deposits to secure a letter of credit), they take the known risk associated with any future extensions of credit—namely, the prior secured creditor may extinguish the debtor's estate and the unsecured creditor may get nothing.²⁹⁰

3. Secured Landlords Versus Over-Secured Creditors

A landlord with a security deposit greater than the Cap is *not* an over-secured creditor and should not be treated as such. Two key points underlie why a landlord should not be forced to disgorge the surplus. First, *Odden* has been read too broadly.²⁹¹ As a result, the proposition that the surplus should be returned to the estate has become improperly ingrained in the law.²⁹² Second, the surpluses of a landlord and mortgagee are not identical, and they should not be treated identically.

²⁸² See, e.g., *Faulkner v. EOP-Colonnade of Dallas, Ltd. P'ship (In re Stonebridge Techs., Inc.)*, 291 B.R. 63, 71 (Bankr. N.D. Tex. 2003), *rev'd*, 430 F.3d 260 (5th Cir. 2005).

²⁸³ See NELSON & WHITMAN, *supra* note 277, at 754.

²⁸⁴ See *id.*

²⁸⁵ See *id.*

²⁸⁶ See *id.*

²⁸⁷ See Radin, *supra* note 263, at 4.

²⁸⁸ See, e.g., 11 U.S.C. § 507 (2000) (rules of ranking creditor classes by priority).

²⁸⁹ See Radin, *supra* note 263, at 3–4 (“[T]here was always some method by which *all* the creditors were compelled to accept some arrangement or some disposition of their claims against the bankrupt's property, whether they agreed to it or not.”).

²⁹⁰ See *id.*

²⁹¹ See St. James, *supra* note 3, at 314–15.

²⁹² See *id.*

The legislative history of the Cap states the following: “This paragraph will not overrule *Oldden* or the proposition for which it has been read to stand: To the extent a landlord has a security deposit *in excess of* the amount of his claim allowed under this paragraph, the excess comes into the estate.”²⁹³ *Oldden*, however, did *not* address this issue. In *Oldden*, the security deposit was in the form of cash and *less than* the amount of the landlord’s capped claim.²⁹⁴ The court held a landlord’s cash security deposit must be applied against its capped claim rather than its gross claim.²⁹⁵ Not until the last paragraph of the opinion, in dicta, did the court mention the prohibition against landlords retaining security deposits in excess of the Cap.²⁹⁶

The court’s basis for prohibiting landlords from retaining security deposits in excess of the Cap is inapplicable to the tenant-debtor who rejects a lease.²⁹⁷ The court explicitly stated a landlord should be entitled to only the amount of the Cap, regardless of the size of the security deposit, “otherwise the security would be in the nature of forfeiture in the event of bankruptcy, and forfeitures are not favored by courts.”²⁹⁸ For this proposition, the court cited a 1925 case that required a security deposit be returned to the tenant-debtor who had filed for bankruptcy but had paid all accrued rent and performed all obligations under the lease.²⁹⁹ This situation is not analogous to a tenant-debtor who rejects a lease.³⁰⁰ The rejection of a lease in bankruptcy is tantamount to a breach,³⁰¹ and the Bankruptcy Code holds the tenant liable for damages.³⁰² A tenant who has not breached a lease is not liable for damages, so there is no reason to allow the landlord to keep the security deposit as there is when a tenant has breached. Additionally, the Bankruptcy Code provides a number of remedies by which a trustee can avoid “forfeitures,”³⁰³ however, none of these allow a trustee to recover letter of credit proceeds held in excess of the Cap.³⁰⁴

²⁹³ H.R. REP. NO. 95-595, at 353–54 (1974), as reprinted in 1978 U.S.C.C.A.N. 5963, 6309.

²⁹⁴ *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 917 (2d Cir. 1944).

²⁹⁵ *Id.* at 921.

²⁹⁶ *Id.*

²⁹⁷ See *St. James*, *supra* note 3, at 316.

²⁹⁸ *Id.*

²⁹⁹ *Seattle Rialto Theatre Co. v. Heritage*, 4 F.2d 668, 670 (9th Cir. 1925).

³⁰⁰ See *Oldden*, 143 F.2d at 921.

³⁰¹ 11 U.S.C. § 365(g) (2000).

³⁰² *Id.*

³⁰³ See, e.g., *id.* § 541(c)(1)(B) (ipso facto provisions); *id.* § 547 (preferential transfers); *id.* § 548 (fraudulent transfers).

³⁰⁴ See *infra* Part III.B.1.

Further, the legislative history itself, which is based on *Oldden*, is contradictory.³⁰⁵ The language that a security deposit in excess of the Cap is to be returned to the estate³⁰⁶ is at odds with the following passage that is now generally accepted as the purpose of the statute:³⁰⁷ “to compensate the landlord for his loss while not permitting a claim so large . . . as to prevent *other* general unsecured creditors from recovering a dividend in the estate.”³⁰⁸ The use of the word “other” suggests Congress viewed landlords as general unsecured creditors as opposed to secured creditors.³⁰⁹ Recognizing that the unique nature of a long term lease obligation would translate into a potential windfall for landlord-creditors, Congress enacted the Cap in an attempt to even the playing field among all unsecured creditors.³¹⁰ Congress, however, did not intend to apply the Cap to the landlord’s secured claim.³¹¹ The subsequent statement that a landlord “will not be permitted to offset his actual damages against his security deposit and then claim for the balance under this paragraph,”³¹² the holding of *Oldden*,³¹³ does not mandate secured claims be limited. Functionally, it simply means the secured claim operates to extinguish the unsecured claim.³¹⁴

Notwithstanding which side of the *Oldden* legislative history interpretation one comes down on, the “surpluses” of a landlord and mortgagee are not identical. Although a security deposit greater than the Cap and a mortgage where the value of the subject property exceeds the debt both involve a “surplus,” they are not analogous. There are three important differences between the two that suggest the landlord should not be treated like an oversecured mortgagee, nor should the landlord be required to return the surplus.³¹⁵

³⁰⁵ See *infra* notes 306–09 and accompanying text.

³⁰⁶ H.R. REP. NO. 95-595, at 354 (1974), as reprinted in 1978 U.S.C.C.A.N. 5963, 6309.

³⁰⁷ *Redback Networks, Inc. v. Mayan Networks Corp.* (*In re Mayan*), 306 B.R. 295, 298 (B.A.P. 9th Cir. 2004).

³⁰⁸ H.R. REP. NO. 95-595, at 353, as reprinted in 1978 U.S.C.C.A.N., at 6309 (emphasis added).

³⁰⁹ See *id.*

³¹⁰ *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1944). It was also influential to the *Oldden* court, and presumably to Congress, that the landlord has the opportunity to reacquire his property with little, if any, diminution in value. *Id.*

³¹¹ See H.R. REP. NO. 95-595, at 354, as reprinted in 1978 U.S.C.C.A.N., at 6309.

³¹² *Id.*

³¹³ *Id.*

³¹⁴ See *id.*

³¹⁵ See *infra* notes 316–32 and accompanying text.

First, the “baselines” are different. The baseline for the Cap is determined by a statutorily imposed formula³¹⁶ that represents an arbitrary percentage of the landlord’s damages and has no relation at all to the landlord’s bargained for security.³¹⁷ The mortgagee’s baseline, however, is the amount of debt.³¹⁸ This is a bargained-for amount between the two parties necessary to make the mortgagee whole.

Second, the debtor in each relationship has contracted for, and expects (in the event of default) a distinctly different result with regard to his counterpart’s surplus.³¹⁹ The tenant-debtor understands, and may have specifically contracted, that the landlord will keep the full security deposit.³²⁰ The tenant does not expect a return of any portion of the surplus.³²¹ The mortgagor-debtor, however, understands that upon default, he can expect a return of the surplus to the extent the value of his property exceeds the amount of the debt.³²²

Third, there is an inherent difference between cash (or cash equivalent) collateral and real estate collateral.³²³ A cash deposit is an exact amount of money. Thus, it can be tendered as security for an exact debt without concern for whether the value of the security is more or less than the principal amount of the debt.³²⁴ Real estate, however, is subjectively valued and indivisible.³²⁵ A mortgagor cannot transfer an interest in one room of a house, for example, and secure a debt for the precise dollar value of that room.³²⁶ An obvious result is that a mortgagee’s security interest may be more or less than the amount of debt at the time of foreclosure.³²⁷ If the value of the security interest (the property) is more than the debt, the mortgagee may not be entitled to the full value of the security interest.³²⁸ On the other hand, with *cash* posted

³¹⁶ 11 U.S.C. § 502(b)(6) (2000).

³¹⁷ *See id.*

³¹⁸ *See* NELSON & WHITMAN, *supra* note 277, at 95. Other factors may be relevant for the decision to enter into a mortgage, such as the loan-to-value ratio or the existence of prior mortgages, but for purposes of recovery, the only relevant factor is the amount of debt. *Id.*

³¹⁹ *See infra* notes 320–22 and accompanying text.

³²⁰ *E.g.*, Solow v. PPI Enters., Inc. (*In re* PPI Enters., Inc.), 324 F.3d 197, 210 (3d Cir. 2003).

³²¹ *See id.*

³²² *See* NELSON & WHITMAN, *supra* note 277, at 678.

³²³ *See infra* notes 324–29 and accompanying text.

³²⁴ *See, e.g.*, Oldden v. Tonto Realty Corp., 143 F.2d 916, 917 (2d Cir. 1944).

³²⁵ *See* Centex Homes Corp. v. Boag, 320 A.2d 194, 196 (N.J. Super. Ct. 1974) (discussing the principle of specific performance as a remedy for breach of a contract to transfer an interest in land).

³²⁶ *See id.*

³²⁷ *See* NELSON & WHITMAN, *supra* note 277, at 680.

³²⁸ *Id.*

as security, both parties understand the landlord is entitled to the full amount posted as security.³²⁹

In short, closer scrutiny of *Oldden* and the legislative history of the Cap, plus the inherent differences between the surplus of a mortgagee and a landlord, demand a landlord not be required to disgorge its security deposit in excess of the Cap.³³⁰ The counter-argument favored by the courts is that a cash security deposit is property of the estate and therefore the surplus must be returned to the estate.³³¹ A letter of credit is not property of the estate, however, and therefore deserves special treatment.³³²

B. *Special Treatment for Letters of Credit*

The foregoing analysis intentionally avoids making a distinction between cash security deposits provided directly by the tenant and letters of credit issued by third parties for the benefit of the landlord. Indeed, when analyzing the landlord as a secured creditor, similar arguments can be posited for each. However, the strongest rebuttal to retaining a cash security deposit in excess of the Cap is that a cash security deposit is presumptively refundable to the tenant,³³³ and therefore becomes property of the estate upon a bankruptcy filing.³³⁴ It arguably has the “impact on the estate” that the *Mayan* court cautioned against,³³⁵ and the landlord should therefore not retain the surplus.³³⁶ Nevertheless, the strongest argument against retaining a *cash* security deposit is also the foundation of the argument for allowing the landlord to retain *letter of credit* proceeds; that is, a letter of credit is *not* part of the estate.³³⁷ Thus, letters of credit deserve special treatment, and landlords who are astute enough to bargain for a letter of credit should not suffer the same fate as those holding only cash security deposits.³³⁸

³²⁹ See, e.g., *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003). This understanding is often written into the lease between the two parties. *Id.*

³³⁰ See *St. James*, *supra* note 3, at 314–19.

³³¹ See *In re PPI Enters., Inc.*, 324 F.3d at 208.

³³² *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan)*, 306 B.R. 295, 299 (B.A.P. 9th Cir. 2004).

³³³ *Id.* at 304 (Klein, J., concurring).

³³⁴ *Id.* at 304 n.6 (“H.R. Rep. No. 95-595 and S. Rep. No. 95-989 each say, ‘the right to a refund is property of the estate.’”).

³³⁵ *Id.* at 299.

³³⁶ *Id.*

³³⁷ E.g., *Faulkner v. EOP-Colonnade of Dallas, Ltd. P’ship (In re Stonebridge Techs., Inc.)*, 291 B.R. 63, 70 (Bankr. N.D. Tex. 2003), *rev’d*, 430 F.3d 260 (5th Cir. 2005).

³³⁸ See *Winick*, *supra* note 13, at 764.

Inherent in the Independence Principle are two key points that should protect letters of credit proceeds. First, there is no bankruptcy mechanism for a tenant to recover money properly drawn on a letter of credit.³³⁹ Second, the current judicial reasoning regarding letters of credit is inconsistent with Congressional policy.³⁴⁰

1. Access to Letter of Credit Proceeds—The Fifth Circuit’s Argument

There is no bankruptcy mechanism to recover proceeds drawn on a letter of credit.³⁴¹ Take, for example, the situation in which the tenant has granted a security interest in its bank cash deposits as security for its reimbursement obligation in the event a draw is made against the letter of credit.³⁴² Assuming the cash deposits are at least equal to the maximum amount that can be drawn down on the letter of credit, the bank is fully secured. Nevertheless, the transfer of the security interest in the tenant’s property occurred not upon the beneficiary’s draw on the letter of credit.³⁴³ Rather, it took place when the letter of credit was issued.³⁴⁴ As of the date of issuance, the bank has a contingent claim against the tenant secured by a valid and protectable property interest in the cash deposits.³⁴⁵ Although the landlord’s future draw on the letter of credit transforms the bank’s contingent claim into a non-contingent claim, there is no additional transfer of property by the tenant at that time.³⁴⁶ Thus, upon default by the tenant and the draw on the letter of credit by the landlord, the landlord is not acquiring property of the tenant which the tenant has a right to recover.³⁴⁷

The Cap is not an avoidance provision.³⁴⁸ If a landlord draws on the letter of credit and those proceeds exceed the Cap, neither the Cap nor any other provision of the Bankruptcy Code give the tenant a cause of action to recover

³³⁹ See Bartell, *supra* note 165, at 835–37.

³⁴⁰ See St. James, *supra* note 3, at 316.

³⁴¹ See Bartell, *supra* note 165, at 835–37.

³⁴² See, e.g., MCCULLOUGH, *supra* note 8, § 3.04(2).

³⁴³ Bartell, *supra* note 165, at 831.

³⁴⁴ *Id.* (citing P.A. Bergner & Co. v. Bank One, Milwaukee, N.A. (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1122 (7th Cir. 1998); Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 591 (5th Cir. 1987); Miller v. Perini Corp. (*In re* A.J. Lane & Co.), 115 B.R. 738, 741 (Bankr. D. Mass. 1990); Briggs Transp. Co. v. Norwest Bank Minneapolis, N.A. (*In re* Briggs Transportation Co.), 37 B.R. 76, 80 (Bankr. D. Minn. 1984)).

³⁴⁵ Bartell, *supra* note 165, at 831.

³⁴⁶ *Id.*

³⁴⁷ *Id.*

³⁴⁸ See 11 U.S.C. § 502(b)(6) (2000).

those excess proceeds from the landlord.³⁴⁹ The Bankruptcy Code provides certain avoiding powers that allow a tenant to recover unauthorized transfers of property of the estate;³⁵⁰ because the Independence Principle shelters letter of credit proceeds from being property of the estate,³⁵¹ however, these provisions are not applicable.³⁵² While some may read the *Stonebridge* district court decision to bestow avoidance powers upon the Cap, the Fifth Circuit made clear that *Stonebridge* should not be interpreted for this purpose.³⁵³

The Cap does not apply to letters of credit because the landlord is not required to file a claim as a condition to making a draw on a letter of credit.³⁵⁴ Rather, filing a claim “is an essential precondition to applying the damages cap at all.”³⁵⁵ If the landlord files a claim under 11 U.S.C. § 501, and if there is an objection to the claim, only then does the Cap come into play.³⁵⁶ Four conditions must occur for the Cap to apply. A landlord³⁵⁷ must file a claim³⁵⁸ for damages resulting from the termination of a lease of real property,³⁵⁹ and the debtor must file an objection.³⁶⁰ The statute, however, does not address claims by letter of credit issuers or guarantors who make payment to a landlord on behalf of the tenant.³⁶¹

A letter of credit does not give rise to a bankruptcy claim because a landlord need not obtain relief from the stay to make the draw.³⁶² A landlord, like a mortgagee, must file his claim under § 501 for it to be subject to the Cap.³⁶³ This is certainly true for a landlord’s unsecured claim, about which

³⁴⁹ See Bartell, *supra* note 165, at 835–37.

³⁵⁰ See, e.g., 11 U.S.C. §§ 547, 548, 549.

³⁵¹ Redback Networks, Inc. v. Mayan Networks Corp. (*In re* Mayan), 306 B.R. 295, 299 (B.A.P. 9th Cir. 2004).

³⁵² If the letter of credit is issued within ninety days prior to filing for bankruptcy, however, the entire issuance of the letter of credit may be avoided as a preferential transfer. See 11 U.S.C. § 547.

³⁵³ EOP-Colonnade of Dallas, Ltd. P’ship v. Faulkner (*In re* Stonebridge Techs., Inc.), 430 F.3d 260, 270 (5th Cir. 2005) (citing Bartell, *supra* note 165, at 835–36).

³⁵⁴ *Id.* at 270.

³⁵⁵ *Id.*

³⁵⁶ 11 U.S.C. § 502(a)-(b).

³⁵⁷ *Id.* § 502(b)(6).

³⁵⁸ *Id.* § 502(a).

³⁵⁹ *Id.*

³⁶⁰ *Id.*

³⁶¹ See *id.* § 502.

³⁶² EOP-Colonnade of Dallas, Ltd. P’ship v. Faulkner (*In re* Stonebridge Techs., Inc.), 430 F.3d 260, 270 (5th Cir. 2005).

³⁶³ *Id.*

there is no disagreement that the Cap applies.³⁶⁴ This is *almost* certainly true for a landlord who holds a cash security deposit paid by the tenant.³⁶⁵ The cash security deposit is property of the estate,³⁶⁶ so the holder of the deposit is no different from a mortgagee.³⁶⁷ A mortgagee must file a claim under § 501 and seek relief from the stay to have legal authority to execute on its collateral.³⁶⁸ The argument follows that a landlord should not be able to retain property of the estate (cash security deposit) without first filing a claim and obtaining relief from the stay.³⁶⁹ However, this argument is inapplicable when the landlord draws on a letter of credit, which is not property of the estate and for which no relief from the stay is necessary.³⁷⁰ Therefore, a § 501 claim does not need to be filed.³⁷¹ Because no § 501 claim must be filed for the landlord to draw on the letter of credit, the proceeds of same, regardless of amount, should not be subject to the Cap.³⁷²

2. Congressional Policy

Current judicial reasoning is inconsistent with Congressional policy. None of the seminal cases presented above held the proceeds of a letter of credit are property of the estate.³⁷³ For this reason, a landlord holding a letter of credit should not be governed by the same rules applicable to a mortgagee, or a landlord with a cash security deposit, in order to recover its security.³⁷⁴ Unlike a mortgagee, a landlord is *not* required to seek relief from the automatic stay to draw down on a letter of credit.³⁷⁵ The *Mayan* court, however, called a “red

³⁶⁴ See, e.g., *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan)*, 306 B.R. 295, 297 (B.A.P. 9th Cir. 2004).

³⁶⁵ See *id.* at 304 n.6.

³⁶⁶ *Id.*

³⁶⁷ See *NELSON & WHITMAN, supra* note 277, at 750–51 (“The most immediate impact of the debtor bankruptcy on the real estate mortgagee is the automatic stay.”).

³⁶⁸ See *id.*

³⁶⁹ See *Bartell, supra* note 165, at 835.

³⁷⁰ See *EOP-Colonnade of Dallas, Ltd. P’ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 270 (5th Cir. 2005).

³⁷¹ *Id.*

³⁷² See *id.*

³⁷³ *Farm Fresh, Stonebridge, and Mayan* explicitly recognized a letter of credit and its proceeds are not property of the estate. See *supra* notes 130, 158, 192 and accompanying text. *In re PPI Enterprises, Inc.* recognized the Independence Principle, but did not answer whether letters of credit are property of the estate. See *supra* notes 143, 148 and accompanying text.

³⁷⁴ See *infra* notes 375–406 and accompanying text.

³⁷⁵ E.g., *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 590 (5th Cir. 1987) (“All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all [the] duties required by the letter of credit.”).

herring” because a landlord still must resort to bankruptcy law to determine how to apply the drawn money.³⁷⁶ According to the *Mayan* court, the appropriate analysis is to look to the “impact that the draw upon the letter of credit has on property of the estate.”³⁷⁷

But *Mayan* does not address the right problem. The court’s reasoning is flawed and inconsistent with Congressional policy.³⁷⁸ A letter of credit in excess of the Cap simply does not have the impact on the estate Congress sought to proscribe.³⁷⁹ *Mayan’s* argument addresses only the foreseeable result of Congressional policy, not the policy itself.³⁸⁰ The primary Congressional objective of both the 1934 Bankruptcy Code Amendment³⁸¹ and the Cap³⁸² is to provide relief to landlords.³⁸³ This is not to say *Oldden* was incorrect in stating that Congress balanced three interests in drafting the statute.³⁸⁴ However, it was only necessary to address the second and third interests in order to satisfy the first.³⁸⁵ When considering the historical context of the Great Depression,³⁸⁶ it was landlords, not debtors or other creditors, who were most in need of such legislation.³⁸⁷ Indeed, the legislative history addresses compensation for the landlord first and protection for the unsecured creditors second.³⁸⁸

The primary purpose of the statute does not diminish the legitimate interests Congress sought to protect, however, the *Mayan* court clearly tried to uphold the third “*Oldden* interest” while apparently disregarding the first.³⁸⁹ Allowing a landlord to keep letter of credit proceeds in excess of the Cap does not substantially harm the estate.³⁹⁰ Although the landlord may collect more,

³⁷⁶ *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan)*, 306 B.R. 295, 299 (B.A.P. 9th Cir. 2004).

³⁷⁷ *Id.*

³⁷⁸ *See St. James, supra* note 3, at 316.

³⁷⁹ *See id.*

³⁸⁰ *See id.* (“The statutes . . . were intended to afford relief to landlords.”).

³⁸¹ *See id.* at 312.

³⁸² *See id.* at 316.

³⁸³ *See id.*

³⁸⁴ The three interests are: (1) relief to landlords, (2) relief to bankrupts, and (3) protection of the remaining creditors. *See Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1944).

³⁸⁵ *See Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan)*, 306 B.R. 295, 306 (B.A.P. 9th Cir. 2004) (Klein, J., concurring).

³⁸⁶ *See supra* notes 41–43 and accompanying text.

³⁸⁷ *See supra* notes 41–43 and accompanying text.

³⁸⁸ H.R. REP. NO. 95-595, at 353–54 (1978), as reprinted in 1978 U.S.C.C.A.N. 5963, 6308–10.

³⁸⁹ *See St. James, supra* note 3, at 316.

³⁹⁰ *See Mayan*, 306 B.R. at 306 (Klein, J., concurring).

proportionately, than the other general unsecured creditors, this extra amount is not what the drafters had in mind when they first sought to limit a landlord's recovery.³⁹¹ As long as the landlord cannot collect more, proportionately, from the estate to satisfy its *unsecured* claim, it should not matter that the landlord is also able to realize its secured claim.

Congress was concerned that a landlord with a bankrupt tenant subject to a long term lease may hold an *unsecured* claim, for example, for fifty years of future rent, that would drain the estate if the debtor rejected the lease.³⁹² This is obviously not a reasonable or equitable result,³⁹³ and Congress was correct to ameliorate the situation.³⁹⁴ Thus, the legislative intent was to prevent a landlord from asserting an *unsecured* claim for more than the statutory limit.³⁹⁵ Without such a limitation, lenders would be reluctant, at best, to extend credit to any person or entity that is party to a long-term lease.³⁹⁶ With a Cap, however, creditors can readily ascertain their borrower's maximum exposure to a landlord's claim under a long-term lease in the event of bankruptcy.³⁹⁷ Likewise, a letter of credit held as security is a fixed sum instrument that allows creditors to readily ascertain their borrower's maximum exposure to a landlord's claim under a long term lease in the event of a bankruptcy.³⁹⁸ Thus, proceeds from a letter of credit in excess of the Cap simply do not have the impact on the estate Congress intended to protect against. In fact, in many regards, a letter of credit satisfies the very problem the Cap was promulgated to remedy.

Finally, allowing a landlord to keep letter of credit proceeds in excess of the Cap does not violate any other underlying policy of the statute. It has been argued the most important policy underlying the Cap is to prevent the landlord from receiving a windfall at the other creditors' expense.³⁹⁹ In the example of allowing a landlord's unsecured claim for fifty years rent, this reasoning is sound. To say, however, a landlord receives a windfall by collecting the

³⁹¹ See *id.* at 311 (explaining that § 502(b)(6) is meant to limit the estate's liability, not the landlord's remedy).

³⁹² See, e.g., *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 207 (3d Cir. 2003).

³⁹³ See *id.* (The Cap "reflects Congress's intent to limit lease termination claims to prevent landlords from receiving a windfall over other creditors.").

³⁹⁴ See *id.*

³⁹⁵ *St. James*, *supra* note 3, at 316.

³⁹⁶ See *id.*

³⁹⁷ See *id.*

³⁹⁸ See *id.*

³⁹⁹ Barbara M. Yadley, *Are Letters of Credit Losing Their Independence in Leasing Contexts?*, REAL EST. FIN., 24, 25 (2003).

benefit of his bargain when savvy enough to insist on security is not reasonable.⁴⁰⁰ Only where the contract is inherently unworthy of enforcement,⁴⁰¹ or the result is “unconscionable,”⁴⁰² will a court find unpersuasive the principle of freedom of contract.⁴⁰³ But it is a rare occurrence, if ever, that a commercial real estate lease is so egregious as to be inherently unworthy of enforcement or shocking to the conscience of the court.⁴⁰⁴ Given other protections for commercial real estate in the Bankruptcy Code,⁴⁰⁵ this argument is even more specious. Therefore, provided the bankruptcy estate is protected from an egregiously large unsecured claim from a landlord, the fact that a landlord can retain his bargained-for letter of credit proceeds in excess of the Cap is simply not a windfall.⁴⁰⁶

IV. RESOLVING THE RIGHT PROBLEM

Landlords must be allowed to adequately protect themselves when entering into long-term commercial leases that require the outlay of large sums of money or that are entered into with tenants with less than “triple A” credit ratings. Without such protection, many small or medium sized developers may withdraw from the market, leaving less opportunity for small to medium-sized businesses to procure leased premises for the conduct of their business.⁴⁰⁷ The scarcity of available locations for lease will lead to higher demand, and the developers who remain will be able to charge higher rents, thus further depressing the economy in general.⁴⁰⁸ It is a lose-lose for everyone.

Opportunities for landlords to fully protect themselves are not abundant. In addition to the Fifth Circuit’s newly announced “just don’t file” strategy,⁴⁰⁹ three possibilities appear to be viable today.⁴¹⁰ The first two require careful

⁴⁰⁰ See *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 922 (2d Cir. 1944) (Frank, J., dissenting).

⁴⁰¹ *St. James*, *supra* note 3, at 317.

⁴⁰² U.C.C. § 2-302 (2003).

⁴⁰³ See *St. James*, *supra* note 3, at 317 (“One must look to contracts with minors and incompetents, or contracts which have an illegal purpose; e.g., prostitution, drugs, violence for hire; to find a similar instance of an obligation which is held to be inherently unworthy of enforcement.”); see also U.C.C. § 2-302.

⁴⁰⁴ See *St. James*, *supra* note 3, at 317.

⁴⁰⁵ 11 U.S.C. § 365(b)(3), (d)(3), (h) (2000).

⁴⁰⁶ See *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 922 (2d Cir. 1944) (Frank, J., dissenting).

⁴⁰⁷ See, e.g., Rachele Garbarine, *Commercial Real Estate: New Jersey; After a False Start, a Big Building Awaits Its Tenant*, N.Y. TIMES, May 29, 2002, at C6.

⁴⁰⁸ See *Oldden*, 143 F.2d at 922 (Frank, J., dissenting).

⁴⁰⁹ See *EOP-Colonnade of Dallas, Ltd. P’ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 271 (5th Cir. 2005).

⁴¹⁰ See *infra* notes 411–27 and accompanying text.

navigation between the judicial interpretations of current law. Notwithstanding the direction in which the law seems to be heading, one commentator has opined a letter of credit may not always be limited by the Cap, and has fashioned two constructs to avoid the courts' apparent willingness to apply the Cap to letters of credit.⁴¹¹ These strategies are novel and may even persuade some jurists, but they are clearly efforts to exalt form over substance in order to circumvent the Cap. Similar to the Fifth Circuit's announced strategy, neither of the commentator's strategies are a true judicial resolution. The third possibility requires a revision in the interpretation of the Cap.⁴¹² If the law is to be changed, it must be consistent with both the Independence Principle and Congressional intent.⁴¹³ That consistency will prevail, however, only if the courts accept the premise that the only "impact" that should be relevant is the effect the letter of credit has on the landlord's claim. Moreover, that premise should not work in reverse; that is, the amount drawn by a landlord under a letter of credit should not be impacted by the Cap.

A. Letter of Credit Approaches Today—More Form Over Substance

The courts have implied that when a letter of credit is not the equivalent of a security deposit, the Cap may not apply.⁴¹⁴ Take, for example, the landlord who builds an office tower for his tenant. The costs of construction would normally be amortized and factored into the rental stream with an implicit interest rate.⁴¹⁵ If the construction costs can be separated from rent, those costs can instead be documented outside the lease as a loan with a separate promissory note and agreement.⁴¹⁶ The loan would include traditional lending provisions, and the loan payments would be separate from the rent payments.⁴¹⁷ The landlord would require two separate letters of credit—one to secure the lease and one for the loan—neither would make reference to the other.⁴¹⁸ Under this situation, courts may rule the Cap would only apply to the lease, not the loan.⁴¹⁹

⁴¹¹ See Yadley, *supra* note 399, at 26.

⁴¹² See St. James, *supra* note 3, at 322.

⁴¹³ See *id.*

⁴¹⁴ See, e.g., *Solow*, 324 F.3d at 210 (applying the Cap because the parties intended the letter of credit to operate as a security deposit).

⁴¹⁵ See Yadley, *supra* note 399, at 26.

⁴¹⁶ *Id.*

⁴¹⁷ *Id.*

⁴¹⁸ *Id.*

⁴¹⁹ *Id.*

Another potential tactic would be for the landlord to draft the lease to state the letter of credit is “in lieu” of a guaranty.⁴²⁰ *In re PPI Enterprises, Inc.* based its ruling on the language of the lease that said a letter of credit is “in lieu” of a security deposit and as such was not analogous to a guaranty.⁴²¹ Because the parties expressly contracted that the letter of credit operate as a security deposit, the *Stonebridge* district court held it should be treated like one.⁴²² Based on *In re PPI Enterprises, Inc.*, and the several cases that have held a claim against a true third-party guarantor is not limited by the Cap,⁴²³ this may be worthy of consideration. The lease would include no provision for a security deposit, but instead include only a remedy provision which allows the landlord to draw on a letter of credit upon an event of default resulting in the termination or rejection of the lease.⁴²⁴ Then, a court may be prone to adopt the reasoning in those decisions that regard guaranties as being outside of the Cap and allow the landlord his full letter of credit.⁴²⁵

In light of courts’ heavy reliance on *Oldden*, and the language therein which condemns landlords’ actions to “nullif[y] [the Cap] by crafty draftsmanship,”⁴²⁶ it is unlikely the “in lieu of a guaranty” strategy would prove successful. Creating a divisible loan contract within the context of a lease presumably creates a myriad of issues, not the least of which are the accounting and tax consequences for both parties. Both strategies are worthy of some consideration, but until either one withstands scrutiny from the bench, they will be of little practical help. Risk-adverse landlords will find these options, as they had the state of the law pre-Fifth Circuit *Stonebridge*,⁴²⁷ insufficient to justify offering a lease to a tenant of questionable financial stability.

⁴²⁰ *Id.*

⁴²¹ *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003).

⁴²² *See* 291 B.R. at 65.

⁴²³ *See, e.g., Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 300 (B.A.P. 9th Cir. 2004); *Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.)*, 900 F.2d 1184, 1191 (8th Cir. 1990); *Bel-Ken Assocs. Ltd. P’ship v. Clark*, 83 B.R. 357, 358 (D. Md. 1988).

⁴²⁴ *See* *Yadley*, *supra* note 399, at 26.

⁴²⁵ *See id.*

⁴²⁶ *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 920 (2d Cir. 1944).

⁴²⁷ *See supra* Part IIA-D.

B. A Substantive and Rational Approach

The Cap is “not a model of clarity”⁴²⁸ In fact, courts have long struggled with its application, including when it applies, the definition of “rent reserved,” how to handle postpetition rent, when rent becomes due, and to what extent the statute is a formula or a cap.⁴²⁹ The current process is a product of judicial interpretation of Congressional intent and precedent that considered neither security deposits nor the distinction between secured and unsecured claims.⁴³⁰

An improved process can be created that better effectuates the policies of bankruptcy law without undermining the policies of contract law and does not dismantle *Oldden*. The three-step Cap implementation process described in the Introduction of this Comment⁴³¹ is by no means statutorily proscribed. The better process would include a simple fourth step: to the extent a landlord has been compensated from sources other than the bankruptcy estate, the unsecured (Capped) claim is extinguished as to that amount. The fourth step does not work in reverse; i.e., the unsecured (Capped) claim does not extinguish the secured claim.

For example, a landlord who holds a gross claim for \$200 (as determined by state law), a capped claim of \$100 (as determined by the Cap), and collects \$150 from a third party in a letter of credit, should keep the \$150 receipt, but forfeit its claim against the estate. On the other hand, if he collects only \$75 from the third party and the capped claim is still \$100, he has an unsecured claim against the estate for \$25. This is consistent with the holding in *Oldden*,⁴³² upholds the Congressional intent to treat the landlord’s unsecured claim on par with other unsecured creditors, treats landlords who hold security like other secured creditors, upholds freedom of contract, and, most importantly, provides relief to landlords without having the disparate impact on the estate Congress sought to proscribe.

⁴²⁸ *In re Gantos*, 176 B.R. 793, 796 (Bankr. W.D. Mich. 1995).

⁴²⁹ See Lisa Sommers Gretchko, *Coping with Rejection § 502(b)(6)—The Evolving Law of Lease Rejection Damages*, 15 AM. BANKR. INST. J. 36, 36 (Apr. 1996).

⁴³⁰ See St. James, *supra* note 3, at 318.

⁴³¹ See *supra* notes 56–60 and accompanying text.

⁴³² *Oldden* held a landlord’s security deposit must be applied against its capped claim rather than its gross claim. 143 F.2d 916, 920 (2d Cir. 1944). If the Cap were to disregard secured claims in their entirety, the secured claim would then be applied to the gross claim, as opposed to the capped claim. See *id.* at 918. Therefore, a consistent approach would be to always apply the secured claim against the capped claim. The unsecured claim would then be extinguished to the extent of the secured claim, however, the capped claim would not extinguish the secured claim.

The courts addressing the application of the Cap, however, have not yet adopted such an approach. While the *Oldden* court *may* have intended its dicta to be indicative of the manner in which it would have ruled had the specific issue been presented,⁴³³ its application to this issue is inappropriate today. *Oldden* was decided in 1944. The Cap was enacted in 1934 largely as a response to landlords' problems during the Depression.⁴³⁴ At that time in our country's history, the massive commercial construction projects entailing the expenditure of millions of dollars so common in today's world did not exist.⁴³⁵ But today, the frequency, scope, and size of these projects necessitate landlords demand large security deposits in order to ensure that in the event their primary or anchor tenant files for bankruptcy, their own filing will not soon follow.⁴³⁶ In fact, without the ability of real estate developers to freely bargain for the amount of security they believe necessary, it's reasonable to believe many of today's projects would not exist.

Judge Klein, in the *Mayan* concurrence, called out for a "rational analysis" of this issue that would neither encourage nor require that landlords "devise credit enhancements that will not be defeated by bankruptcy."⁴³⁷ The Fifth Circuit's analysis⁴³⁸ reached the correct conclusion, but the rationality of a landlord's recovery turning on whether he files a claim is arguable. The approach developed in this Comment is, in all respects, a rational analysis. Proper deference in proper proportion is accorded to all of the competing policy considerations underlying non-bankruptcy state law and federal bankruptcy law. Current economic realities, including freedom of contract, recognition that landlords are not like every other unsecured creditor, recognition that landlords can sometimes be secured creditors, and recognition that letters of credit are different than cash security deposits, are given due respect. The bankruptcy estate is adequately protected and the Independence Principle is correctly honored. And, as a welcome side effect, it just may

⁴³³ The court, itself, admits it is only speculating. *Id.* at 921.

⁴³⁴ *Id.* at 919–20.

⁴³⁵ *See id.* at 921 (explaining security deposits approaching the statutory limit were unheard of).

⁴³⁶ *See, e.g.,* Garbarine, *supra* note 407, at C3.

⁴³⁷ *Redback Networks, Inc. v. Mayan Networks Corp.* (*In re Mayan Networks Corp.*), 306 B.R. 295, 307 (B.A.P. 9th Cir. 2004) (Klein, J., concurring).

⁴³⁸ *EOP-Colonnade of Dallas, Ltd. P'ship v. Faulkner* (*In re Stonebridge Techs., Inc.*), 430 F.3d 260, 271 (5th Cir. 2005).

promote investment opportunities for small business and enhance competition in the marketplace.

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