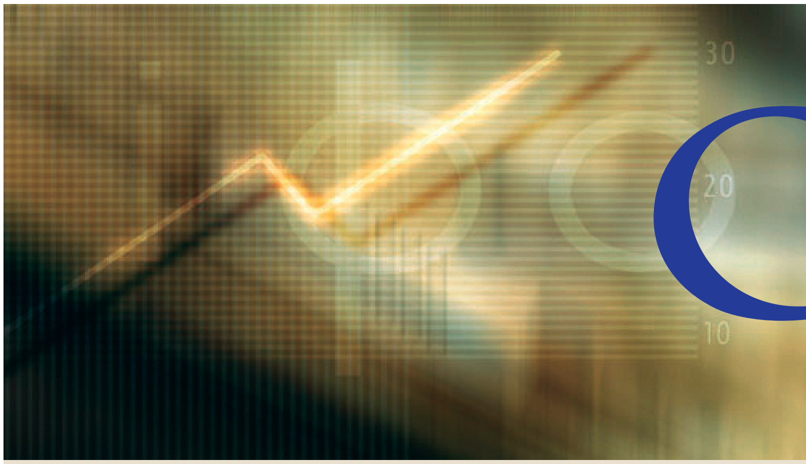

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Protecting the Value of Letters of Credit

By Laura Hebert

Letters of credit are used frequently in many types of business and real estate transactions. They are often accepted and sometimes even preferred as, for example, security deposits for leases, collateral for commercial real estate and business loans, and as guarantees of payment on purchase agreements. A landlord, a lender, or the seller in an asset purchase agreement may require that a letter of credit be provided because, at the time of default after a payment becomes due, the letter of credit will allow its beneficiary to draw the money owed directly from a specified bank rather than having to seek payment from the tenant, borrower, or purchaser. Thus, payment is ensured, even if the party that is obligated to pay is no longer willing or able to do so. But in times of financial instability like the one we are experiencing now, the holder of a letter of credit may find that his or her “guarantee” of payment is worth no more than the paper it is written on.

The danger to holders of letters of credit arises from the ongoing epidemic of bank failures. When a bank fails and is taken over by the Federal Deposit Insurance Corporation (FDIC), the FDIC may not honor the letters of credit issued by the bank. Whether the FDIC will honor a given letter of credit can depend on the type of account established to support it. If the letter of credit is not secured by collateral —and many are not—or is undersecured, the FDIC may view it as an unfunded loan commitment, which it may repudiate. A bank failure is more than a remote possibility these days. The FDIC has taken over 130 U.S. banks or savings and loans so far in 2009, compared to 25 in all of 2008 and three in all of 2007.

A letter of credit is often used to secure a payment obligation arising from an underlying contract. A bank, or “issuer,” issues a letter of credit at the request of the party obligated to pay under the contract, often referred to as the “applicant” or the “account party.” The applicant will promise to reimburse the issuer for amounts paid on the letter of credit and may also be required to deliver cash or other collateral to secure such payments. The party to whom the letter of credit is issued, and who will be authorized to draw on it under certain stated conditions, is the “beneficiary.” The letter of credit becomes a direct obligation of the issuer to the beneficiary. The underlying contract will typically set forth requirements for the letter of credit, specifying, at a minimum, the amount it must cover, the circumstances under which draws may be made, and the documents that the beneficiary must present in order to draw on the letter of credit.

Letter of credit beneficiaries should routinely check certain important details, even in strong economies. For example, beneficiaries should make sure that the draw requirements are clear to all parties because the strictest compliance with the draw requirements will be necessary. To avoid having the issuer reject the draw for noncompliance, the documents necessary to draw on the letter of credit should be agreed upon in advance and attached as exhibits. Also, letters of credit always have expiration dates, which can be a trap for the unwary. Beneficiaries should make sure that the date upon which payment will or may become due is not only within the life of the letter of credit but also permits time to submit a draw and then a redraw if the first is rejected. In difficult economic times like these, an additional important concern is the financial health of the issuer.

Letter of credit beneficiaries can take steps to mitigate the risks presented by bank failures. First, the underlying contract should require that the letter of credit be issued by a specific bank that is satisfactory to the beneficiary or by a bank whose financial strength meets certain criteria such as having a high rating from a rating service like Fitch, Moody's, or Standard & Poor's. Second, the underlying contract should require that the applicant obtain a replacement letter of credit from a different bank if the issuer falls below the required ratings or other criteria. The letter of credit should permit the beneficiary to draw against it if not replaced within the specified time period, even if payment is not yet otherwise owed. Finally, letter of credit beneficiaries should check the financial health of issuers on a regular basis. While the risk of a bank failure can never be eliminated completely, a little extra vigilance can help prevent a beneficiary from being left empty handed.