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USING LETTERS OF CREDIT, CREDIT DEFAULT SWAPS AND OTHER FORMS OF CREDIT ENHANCEMENTS IN NET LEASE TRANSACTIONS

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INTRODUCTION

IN its devastation of the commercial real estate finance industry, the recent credit crunch has created opportunities for real estate investors who are able to cobble together competitive mortgage financing for their acquisitions. Between the end of 2003 and 2006, commercial mortgage-backed securities (CMBS) helped finance roughly half of all domestic commercial real estate acquisitions.[1] CMBS financing is typically nonrecourse, and in recent years provided leverage of roughly seventy-five percent, even in the case of properties net leased[2] to below investment-grade-rated[3] tenants. However,

1. Parke M. Chapman, *CMBS Market Throttles Down*, NAT'L REAL EST. INVESTOR, Jan. 1, 2008, at 14, *available at* http://nreionline.com/finance/cmbs/cmbs_market_drops/.
2. A "net lease" is a property lease in which the lessee agrees to pay, in addition to rent, some or all of the expenses normally associated with ownership, such as utilities, repairs, insurance and taxes.

issuance of domestic CMBS dropped to approximately $12 billion in 2008 from a record of approximately $230 billion in 2007.[4] With the collapse of the CMBS market, and the evaporation of other sources of nonrecourse financing, a net lease real estate investor seeking high leverage financing must either provide a personal guarantee supported by a substantial balance sheet or qualify for credit tenant financing.

In a credit tenant loan (CTL), the lender relies primarily on the credit of the tenant rather than on the value of the property collateralizing the loan.[5] Such tenants are typically investment grade rated by at least one of the major rating agencies. In general, the higher the tenant's credit rating, the cheaper the financing, and the bigger the pool of prospective lenders. As a result, the landlord may in certain cases reduce its cost of capital by enhancing the tenant's credit.

Tenant credit enhancements also provide non-monetary advantages to the landlord. First, by reducing the risk of tenant default, credit enhancements also reduce the risk that the landlord will default on its financing, thereby helping to protect its future credit rating. Second, by assigning the benefits of the credit enhancement to its lender, the landlord may be subject to less stringent loan covenants, and less onerous due diligence requirements imposed by its lender. Finally, the landlord may obtain faster loan approval and funding with an effective credit enhancement.

This article will explore the use of both traditional and nontraditional credit enhancements in net lease transactions and the impact of a tenant bankruptcy on such instruments.

I. ELEMENTS OF A TYPICAL CREDIT TENANT LEASE FINANCING

While billions of dollars in high leverage CTLs have been made through the CMBS market, for now this market has largely disappeared. As a result,

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3. "Investment grade" generally refers to a company whose senior unsecured debt is rated BBB- or better by Standard & Poor's and Fitch, and Baa3 or better by Moody's Investors Service.
4. COMMERCIAL MORTGAGE SEC. ASS'N, COMPENDIUM OF STATISTICS (2008), *available at* http://www.cmbs.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf.
5. *See* NAT'L ASS'N OF INS. COMM'RS, PURPOSES AND PROCEDURES MANUAL OF THE NAIC SECURITIES VALUATION OFFICE pt. 7, § 4(a)(i)(A) (2008) [hereinafter NAIC PURPOSES AND PROCEDURES MANUAL] (on file with the Virginia Law & Business Review).

today most CTLs are made by life insurance companies, which must account for their investments in accordance with the risk-based capital rules established by the National Association of Insurance Commissioners ("NAIC").[6] Under the NAIC rules, a life insurance company making a qualifying CTL is accorded advantageous regulatory accounting treatment for such loans in that the loan results in a lower charge against the life insurance company's balance sheet than conventional mortgages.[7] Specifically, a qualifying CTL is classified as a bond (a Schedule D investment) rather than as a mortgage loan (a Schedule B investment).[8] Since the reserve requirements for investment grade bonds are significantly lower than those for mortgage loans,[9] qualifying CTLs (that is, those qualifying for Schedule D treatment) have significantly lower reserve requirements than do conventional mortgage loans.

In a properly structured CTL, all risks of a loan default other than a lease default by the tenant are minimized. The lease is a triple net lease in which the tenant pays all costs associated with the property, including utilities, maintenances, taxes, and insurance. Often, the lease will be a bond style lease in which the tenant's obligation to pay rent is not excused or reduced for any reason including complete destruction of the premises. If the lease is not a bond style lease, any real estate risks or obligations imposed on the landlord must be mitigated through insurance or other means.[10] In addition, many CTL lenders require a "lockbox" arrangement in which the tenant pays its

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6. *See, e.g.*, Cal. Ins. Code § 739.2 (2008). *See generally*, Kevin Driscoll, *Credit Tenant Loans*, REAL EST. FIN. J., Winter 2002, at 64 [hereinafter *Credit Tenant Loans*].
7. Life, accident, and health insurance companies must establish a reserve (Asset Valuation Reserve) "to offset potential credit-related investment losses on all invested asset categories" subject to limited exclusions. NAT'L ASS'N OF INS. COMM'RS, STATEMENT OF STATUTORY ACCOUNTING PRINCIPLES NO. 7, ASSET VALUATION RESERVE AND INTEREST MAINTENANCE RESERVE ¶ 1(2001) (on file with the Virginia Law & Business Review).
8. *See* NAIC PURPOSES AND PROCEDURES MANUAL, *supra* note 4, at pt. 7, § 4(a)(i)(A). Bonds are reported on Schedule D of a life insurance company's annual report to the Insurance Commissioner while mortgage loans are reported on Schedule B. *See generally*, *Credit Tenant Loans*, *supra* note 6, at 66.
9. *See id.*
10. *See* NAIC PURPOSES AND PROCEDURES MANUAL, *supra* note 5, at pt. 7, § 4(a)(iii)(A). For example, if the tenant is permitted to terminate the lease in the event of casualty or condemnation, the CTL lender will often require (although the NAIC rules do not mandate) a special "Loss of Rents" insurance policy that pays off the lender upon lease termination for casualty or condemnation. After paying off the lender, the insurer is assigned all of the lender's rights under the loan documents. Alternatively, the risk of casualty or condemnation is covered by the tenant's obligation to make a purchase offer for the property in an amount not less than the projected loan balance.

rent directly to the landlord's lender to cover the debt service of the loan.[11] Finally, the borrower-landlord is generally required to be a special purpose entity whose sole asset is the property, whose only business is owning and leasing the property, and whose sole liability is the CTL.[12] This requirement minimizes the risk of the borrower filing for bankruptcy for reasons other than the tenant's breach of the lease.

Some CTL lenders insist on making a tenant bankruptcy or tenant lease default an event of default under the CTL on the theory that the basis for the CTL disappears when the credit tenant disappears. CTLs with such a provision are referred to in this article as "hard CTLs"; those without such a provision are referred to as "soft CTLs." Under a hard CTL, the landlord's loan could be called (and a large prepayment penalty imposed) due to a tenant bankruptcy, even when the landlord is current on its loan payments and is in a position to replace the bankrupt tenant with a stronger tenant. For this reason, a hard CTL imposes significant additional risk on the landlord-borrower. A landlord assigning tenant credit enhancement to its CTL lender should insist that so long as the tenant credit enhancement remains in full force and effect the CTL financing must be "soft."

The holder of a properly arranged CTL owns a debt instrument similar in risk profile to a corporate bond issued by the tenant.[13] As a result, CTL lenders generally will allow the borrower-landlord to finance up to one hundred percent of the cost of acquiring the property. Moreover, CTL lenders generally allow a debt service coverage ratio of 1:1—that is, they will make a loan in which the debt service payments are exactly equal to the rent under the lease. By contrast, other commercial real estate lenders generally require that the property have a value substantially higher than the loan amount, and that the rental payments be substantially higher than the debt service payments in order to provide the lender with a margin of security. Since equity capital commands a higher return than debt capital, an investor who uses high leverage CTL financing to acquire real estate will generally

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11. *See id*, at pt. 7, § 4(a)(iii)(C)(6).
12. Although CTL lenders generally impose this requirement, it is not mandated by the NAIC rules. *See id.* at pt. 7, § 4(a)(i)(E)(6).
13. However, a CTL differs from a corporate bond in one important way: in the event of a tenant bankruptcy, the holder of the bond will have a claim in the tenant's bankruptcy for the full amount of the bond, while the holder of a CTL will (after foreclosing on the property) have a claim in the tenant's bankruptcy that is subject to the damage limitations of Section 502(b)(6) of the Bankruptcy Code. *See infra* Section II.

have a lower cost of capital than one who uses conventional financing (which will have lower leverage and require a greater equity investment).

Commercial tenants often require that their leases be structured so that the landlord's CTL financing is not reflected on the tenant's balance sheet under U.S. accounting rules.[14] A lease that is not a sale-leaseback is off-balance-sheet for the tenant if (a) the lease qualifies as an operating lease under FAS 13[15] and (b) the tenant is not required to "consolidate" the landlord, that is, include the landlord in the tenant's financial statements.[16] A

14. Although the Securities and Exchange Commission (SEC) has the statutory authority to establish financial accounting and reporting standards for publicly held companies, since 1938 it has relied on the private sector to formulate what is now termed "generally accepted accounting principles" or "GAAP." *See, e.g.*, Securities Act of 1933, 15 U.S.C. §§ 77s(a)–(b) (2002). Since 1973, the primary authority for GAAP has been the Financial Accounting Standards Board (FASB), a private, independent organization composed of seven board members and additional support staff. The SEC has proposed a "roadmap" for the "convergence" of GAAP and international financial reporting standards. Under this roadmap, all U.S. issuers could be required to use international financial reporting standards rather than GAAP for financial reporting as early as 2014. *See* Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, 73 Fed. Reg. 70816 (Nov. 21, 2008). A joint project of FASB and the International Accounting Standards Board on leases is working towards the elimination of off-balance-sheet treatment of leases. Specifically, the boards tentatively decided in July 2008 that a tenant should recognize its right-of-use under a lease as an asset and its lease obligations as a liability and should initially measure both its right-of-use asset and its lease obligations at the present value of the expected lease payments. FASB, Minutes of the July 23, 2008 Board Meeting: Leases Technical Discussion, http://www.fasb.org/board_meeting_minutes/07-23-08_leases.pdf; Int'l Accounting Standards Bd., Minutes of July 24, 2008 Board Meeting of the Leases Working Group, http://www.iasb.org/Current+Projects/IASB+Projects/Leases/Meeting+Summaries+and+Observer+Notes/IASB+July+2008.htm.

15. Accounting For Leases, Statement of Financial Accounting Standards No. 13 (Fin. Accounting Standards Bd. 1976) [hereinafter FAS 13]. To be classified as an operating (off-balance-sheet) lease under Paragraph 7 of FAS 13, none of the following four criteria can exist at lease inception:

> a. The lease transfers ownership of the property to the lessee by the end of the lease term . . . . b. The lease contains a bargain purchase option . . . . c. The lease term . . . is equal to 75 percent or more of the estimated economic life of the leased property . . . . d. The present value at the beginning of the lease term of the minimum lease payments . . . equals or exceeds 90 percent of the . . . fair value of the leased property.

Id.

16. Consolidation of Variable Interest Entities, FASB Interpretation No. 46 (Fin. Accounting Standards Bd. 2003). So long as the tenant does not guarantee the landlord's debt or the residual value of the property, the tenant should not be required to consolidate the landlord in the tenant's financial statements. *See* Ken Miller, *Off-Balance-Sheet Sale-Leasebacks and Synthetic Leases after Enron*, CAL. REAL PROP. J., Fall 2002, at 3, 8–9.

net lease with a term of twenty to twenty-two years or less typically satisfies these requirements so long as the lease does not contain a bargain purchase option and the lease does not transfer title to the property to the tenant. By contrast, in a sale-leaseback transaction, for the tenant to receive off-balance-sheet treatment, the transaction must satisfy the foregoing requirements as well as the requirements for sale-leaseback treatment under FAS 98.[17] Under FAS 98, a transaction structured as a sale-leaseback will be respected for accounting purposes only if: (i) the buyer-landlord receives all of the risks and rewards of ownership other than the right of possession during the lease term, and (ii) the seller-tenant retains no continuing involvement in the property other than the right of possession during the lease term.[18]

II. TREATMENT OF THE COMMERCIAL LANDLORD'S CLAIM FOR RENT IN A TENANT BANKRUPTCY

The filing of a bankruptcy petition creates an automatic stay against any enforcement action against the debtor.[19] In a tenant bankruptcy, the automatic stay precludes the landlord not only from suing to evict the tenant or collect past due rent but also, according to some courts, from giving a notice of default for the purpose of terminating the lease.[20] The bankruptcy trustee must assume or reject the lease within 120 days of the bankruptcy filing, a period which may be extended by the bankruptcy court for an additional 90 days for good cause.[21] The trustee is required to continue to pay rent and otherwise comply with the lease while it is considering whether to assume or reject the lease,[22] and the landlord has a first priority administrative claim for such post-petition rent.[23] In order to assume the lease, the trustee must cure or provide adequate protection of past defaults,

17. Accounting For Leases, Statement of Financial Accounting Standards No. 98 (Fin. Accounting Standards Bd. 1988) [hereinafter FAS 98] (on file with the Virginia Law & Business Review).
18. *See id.* ¶¶ 48, 52.
19. 11 U.S.C. §§ 362(a), (c), (d)(1) (2006).
20. *See* 9B Am. Jur. 2d Bankruptcy § 1797 (2008). *See also In re* Metrobility Optical Sys., Inc. 268 B.R. 326, 330 (Bankr. D. N.H. 2001). Landlord may seek relief from the automatic stay or may file a motion to compel performance under Section 365. *In re* Stonebridge Technologies, Inc., 430 F.3d 260, 272 (5th Cir. 2005); *In re* Food City, Inc., 95 B.R. 451, 457 (Bankr. W.D. Tex. 1988). *See also* COLLIER ON BANKRUPTCY ¶ 362.03(5)(a) (15th ed. 2008) [hereinafter COLLIER].
21. 11 U.S.C. § 365(d)(4) (2006).
22. § 365(d)(3).
23. COLLIER, *supra* note 20, ¶ 503.04; *In re Food City, Inc.*, 95 B.R. at 454.

compensate or provide adequate assurance that the trustee will promptly compensate the landlord for monetary loss from default, and provide adequate assurance of future performance under the lease.[24] If the trustee rejects the lease or is deemed to have rejected the lease by failing to timely assume the lease, the trustee must immediately surrender the property to the landlord.[25]

Lease rejection constitutes a breach of the lease[26] but does not terminate the lease.[27] Following lease rejection, the landlord has non-priority claims against the tenant for both pre-petition rent and lost future rents under the lease.[28] The landlord's claim for future rent under the lease is limited by Section 502(b)(6) of the Bankruptcy Code to the rent reserved in the lease "for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease."[29] This limitation is referred to in this article as the "lease rejection damages cap" or simply the "cap." The landlord's claim for pre-petition rent is not subject to the cap. The purpose of the cap is "to compensate the landlord for its 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."[30] The cap is not reduced by the amount of the landlord's administrative rent claim for the post-petition, pre-rejection period[31] or by any rent payments from a replacement tenant.[32]

If the trustee assumes and then rejects the assumed lease, the landlord is allowed an administrative claim for all monetary obligations due for the period of two years following the later of the rejection date or the date of actual turnover of the premises, and the landlord's claim for remaining sums

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24. § 365(b).
25. § 365(d)(4)(A).
26. § 365(g).
27. *In re* Austin Dev. Co., 19 F.3d 1077, 1083 (5th Cir. 1994); McLaughlin v. Walnut Properties, 14 Cal. Rptr. 3d 369, 375 (Cal. Ct. App. 2004).
28. *See generally* DAVID R. KUNEY, BANKRUPTCY ISSUES FOR COMMERCIAL LANDLORDS, TENANTS AND MORTGAGEES ch. 5 (2006) [hereinafter KUNEY].
29. 11 U.S.C. § 502(b)(6)(A) (2006). This time period begins on 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." *Id.* For a complete discussion of this cap, see KUNEY, *supra* note 28, at 60–73.
30. S. REP. NO. 95-989, at 63 (1978) *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5849.
31. *In re* First Alliance Corp., 140 B.R. 531, 533 (B.A.P. 9th Cir. 1992).
32. *In re* Atl. Container Corp., 133 B.R. 980, 989–90 (Bankr. N.D. Ill. 1991).

due for the balance of the term of the lease is subject to the lease rejection damages cap.[33]

III. TRADITIONAL TENANT CREDIT ENHANCEMENTS

A. Cash Security Deposit

While a tenant security deposit is a standard requirement for residential leases and leases of multi-tenant commercial buildings, security deposits are rarely used in credit tenant net lease transactions for several reasons. First, given that net leases often have terms exceeding twenty years, to obtain meaningful protection against a tenant's default and the loss of future rents, a landlord might well require a security deposit in excess of one year's rent. Tenants are understandably reluctant to give up the use of a significant amount of cash for such a long period of time.

Second, a tenant providing a cash security deposit to its landlord in a sale-leaseback transaction may be deprived of off-balance-sheet treatment under U.S. accounting rules. As discussed in Section II above, in order for a seller-tenant to achieve off-balance-sheet treatment of a sale-leaseback of real estate, FAS 98 requires, among other things, that the seller-tenant "transfer all of the . . . risks and rewards of ownership [of the property] as demonstrated by the absence of any other continuing involvement by the [seller-tenant]."[34] FAS 98 specifically identifies as a form of prohibited continuing involvement the seller-tenant's collateralization of the leaseback payments with other assets of the seller-tenant on behalf of the buyer-landlord.[35] As a result, a seller-tenant providing a significant cash security deposit to its buyer-landlord in a sale-leaseback transaction appears to be prohibited by FAS 98 from obtaining off-balance-sheet treatment of the sale-leaseback under U.S. accounting rules.

Third, from the landlord's standpoint, a tenant security deposit offers limited protection. In the case of a tenant bankruptcy, the security deposit becomes an asset of the tenant's estate in bankruptcy,[36] and the landlord

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33. 11 U.S.C. § 503(b)(7) (2006). It is unclear whether this two-year "cap" is a liquidated damages provision, basically accelerating the rent for two years, or whether it imposes on the landlord a duty to mitigate. *See* MILTON R. FRIEDMAN & PATRICK A. RANDOLLPH, JR., FRIEDMAN ON LEASES § 19A:4 (5th ed. 2008).
34. FAS 98, *supra* note 17, ¶ 7.
35. FAS 98, *supra* note 17, ¶ 12(d).
36. *See In re* Whiting Pools, Inc., 462 U.S. 198, 203 (1983); *In re* Mayan Networks Corp., 306 B.R. 295, 304 (B.A.P. 9th Cir. 2004) (Klein, J., concurring).

cannot use the security deposit to cover its damages without first obtaining relief from the automatic stay. Furthermore, the landlord's claim against the deposit is subject to the lease rejection damages cap. If the security deposit exceeds the cap, the landlord may retain a portion of the deposit equal to the cap but must return the balance to the bankruptcy estate.[37] If the security deposit is less than the landlord's damages as well as the bankruptcy cap, the landlord will have a secured claim in the amount of the cash deposit, and an unsecured claim for the remaining damages, but not in an amount exceeding the cap.[38] In other words, the security deposit is applied in reduction of the amount of the cap, and any damages exceeding the cap are disallowed.[39]

B. Parent Guarantee

If the tenant has an affiliate with superior credit to that of the tenant, the tenant may wish to have its affiliate guarantee the tenant's obligations under the lease. Typically, the affiliate providing the guarantee is the tenant's parent. A parent (or other affiliate) lease guarantee is a straightforward and efficient way to enhance the tenant's credit.

A parent guarantee does not pose an obstacle to a seller-tenant seeking to keep a sale-leaseback off of its balance sheet. Under U.S. accounting regulations, an unsecured guarantee of the lease obligations of one member of a consolidated group by another member of the consolidated group is not a form of prohibited "continuing involvement" that precludes off-balance-sheet accounting in the consolidated financial statements.[40] Hence, a parent corporation will not be precluded from off-balance-sheet accounting in its consolidated financial statements if it provides an unsecured guarantee of its subsidiary's lease obligations.

A parent guarantee provides certain advantages to the landlord in the tenant's bankruptcy, so long as the parent remains out of bankruptcy. The automatic stay triggered by the tenant's bankruptcy does not prevent the landlord from pursuing an independent claim against the tenant's lease guarantor.[41] In addition, the courts have consistently held that the lease

37. H.R. REP. NO. 95-595, at 353–54 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6309.
38. *Id.*
39. *In re* AB Liquidating Corp., 416 F.3d 961, 963–64 (9th Cir. 2005).
40. Unsecured Guarantee by Parent of Subsidiary's Lease Payments in a Sale-Leaseback Transaction, EITF Abstracts, Issue No. 90-14 (1991), http://www.fasb.org/pdf/abs90-14.pdf [hereinafter EITF 90-14].
41. COLLIER, *supra* note 20, ¶ 362.03(3)(d).

rejection damages cap does not limit the landlord's claim against the guarantor.[42] In so holding, the courts have invoked Section 524(e) of the Bankruptcy Code, which provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt."[43] By contrast, a Southern District of New York court held that the cap limited the subrogation claim of the lease guarantor against the bankrupt tenant.[44]

Often when a tenant files bankruptcy or defaults on a lease, the tenant's parent and other affiliates will file a consolidated bankruptcy proceeding. If the parent guarantor files for bankruptcy, the landlord would be prevented by the automatic stay from collecting on the guarantee outside of the bankruptcy proceeding, and the landlord's damages would be subject to the lease rejection damages cap.[45]

In short, a parent guarantee provides effective credit support for the tenant's lease obligations in those situations where the tenant defaults or files bankruptcy without its parent also becoming a debtor in bankruptcy.

C. Letter of Credit

The landlord may find that it can significantly improve the terms of its financing by providing its lender with an irrevocable standby letter of credit securing all or a portion of the lease payments. A standby letter of credit is an obligation of the issuing bank to pay the beneficiary upon certification of nonperformance of an agreement.[46] The certification may take the form of a written statement signed by the beneficiary certifying simply that the applicant has not performed.[47] Upon payment under the letter of credit, the issuing

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42. *See, e.g.*, *In re* Modern Textile, Inc., 900 F.2d 1184, 1191 (8th Cir. 1990); Bel-Ken Associates v. Clark, 83 B.R. 357, 358 (D. Md. 1988); Things Remembered, Inc. v. BGTV, Inc., 151 B.R. 827, 831 (Bankr. N.D. Ohio 1993); *In re* Danrik, Ltd., 92 B.R. 964, 967–68 (Bankr. N.D. Ga. 1988). *See generally* KUNEY, *supra* note 28, at 66–68.
43. 11 U.S.C. § 524(e) (2006).
44. *In re* Denby Stores, Inc., 86 B.R. 768, 781 (S.D.N.Y. 1988).
45. *In re* Arden, 176 F.3d 1226, 1227 (9th Cir. 1999); *In re* Episode USA, Inc., 202 B.R. 691, 696 (Bankr. S.D.N.Y. 1996).
46. *See generally* John F. Dolan, THE LAW OF LETTERS OF CREDIT ¶ 1.04 (rev. ed. 2002) (explaining how the nature of the payment trigger differentiates a standby letter of credit from a commercial letter of credit).
47. As stated by one commentator:

> The purpose of the certificate is not to determine whether the recited facts indeed have occurred but to give the bank and the applicant the beneficiary's warranty that they have occurred and therefore give the

bank is entitled to reimbursement from the applicant,[48] who is generally a customer of the bank.

Ordinarily, there are three distinct agreements in a letter of credit transaction: (1) the letter of credit itself; (2) the underlying contract between the applicant and the beneficiary which is supported by the letter of credit; and (3) the reimbursement agreement between the issuing bank and the applicant, under which the bank agrees to issue the letter of credit for a fee, and the applicant agrees to reimburse the bank for any payments under the letter of credit.[49] Under the independence principle, the issuing bank's obligation under the letter of credit is completely independent from the other two contracts.[50]

In a CTL financed lease, the tenant should act as the applicant so that the issuing bank relies on the credit of the tenant. The landlord, being a special purpose entity, would have insufficient credit to obtain a letter of credit. Furthermore, even if one of the landlord's principals were capable of obtaining a letter of credit, such a structure would tie up significant equity and capital of the landlord, thereby increasing the landlord's cost of funds and consequently the tenant's rental rate.

U.S. accounting rules authorize the use of an uncollateralized, irrevocable letter of credit to secure the tenant's lease payments in an off-balance-sheet real estate sale-leaseback. Specifically, under the U.S. accounting rule known as EITF 90-20, a tenant providing such a letter of credit from its bank is not engaging in "continuing involvement" that precludes sale-leaseback accounting under FAS 98.[51] Note that EITF 90-20 allows the tenant to provide a letter of credit securing the lease payments, not the loan payments; thus, the landlord, rather than the lender, will be the beneficiary under the letter of credit.[52] By contrast, U.S. accounting rules preclude the use of a

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bank and the applicant a cause of action against the beneficiary if they have not occurred.

Id. ¶ 1.04 n.70.

48. *See* U.C.C. § 5-108(i)(1) (1998).
49. Ins. Co. of N. Am. v. Heritage Bank, N.A., 595 F.2d 171, 173 (3d Cir. 1979).
50. *See* U.C.C. § 5-103(d).
51. Financial Accounting Standards Board, Emerging Issues Task Force, Impact of an Uncollateralized Irrevocable Letter of Credit on a Real Estate Sale-Leaseback Transaction, EITF Abstracts, Issue No. 90-20 (1991), http://www.fasb.org/pdf/abs90-20.pdf [hereinafter EITF 90-20].
52. For a discussion of the issues relating to a lender's perfection of its interest in a letter of credit provided to the landlord, see Janet C. Norris, *Letters of Credit Posted by Dot-com*

collateralized letter of credit to secure the tenant's lease obligations in an off-balance-sheet real estate sale-leaseback.[53]

A letter of credit obtained by the tenant and issued by a creditworthy bank is more advantageous to the landlord and its lender than a tenant security deposit because it provides much stronger protection against a tenant bankruptcy than does a cash security deposit which, as discussed above, becomes an asset of the bankruptcy estate. Since a letter of credit creates an independent contract between the issuing bank and the beneficiary, in the event of a tenant bankruptcy the proceeds of a letter of credit are not property of the tenant's bankruptcy estate.[54] As a result, absent fraud in the underlying contract, neither the tenant nor the bankruptcy trustee may prevent the issuing bank from distributing the proceeds of the letter of credit by invocation of the automatic stay or otherwise.[55]

1. Application of the Lease Rejection Damages Cap to Letter of Credit Proceeds

Three circuit appeals courts and one bankruptcy appellate panel have recently issued opinions concerning the application of the lease rejection damages cap to letter of credit proceeds. In the most recent case, *In re Stonebridge Technologies*, the landlord drew down the full amount of a secured letter of credit after the tenant filed bankruptcy and rejected the lease.[56] After allowing the letter of credit issuer to obtain reimbursement from a certificate of deposit pledged by the debtor-tenant, the bankruptcy trustee sued the landlord to recover the letter of credit proceeds in excess of the cap. The Fifth Circuit Court of Appeals held that the landlord had correctly applied the proceeds to cover accelerated rent and that the cap did not apply. The court gave two grounds for its refusal to apply the cap. First, Section 502(b)(6) does not contain an avoidance power; "[w]hen the Bankruptcy Code intends to create an avoidance power, it does so expressly in the language of the

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Tenants—How Lenders Can Avoid Becoming a Victim of Tulipmania, CAL. REAL PROP. J., Spring 2000, at 3.

53. FAS 98, *supra* note 17, ¶ 12(d). *See also* EITF 90-20, *supra* note 51.

54. Kellogg v. Blue Quail Energy, Inc., 831 F.2d 586, 589 (5th Cir. 1987); Postal v. Smith, 522 F.2d 791, 795 (9th Cir. 1975) (implying that if the credits had been secured, the court may have decided the case differently). Since a tenant bankruptcy may bar the landlord from sending a notice of default, either the letter of credit should permit the landlord to draw on the letter upon landlord's certification of default without notice to tenant, or the letter of credit should not require notice of default if sending notice is barred by law.

55. *See* Dolan, *supra* note 46, ¶ 7.03[3].

56. 430 F.3d 260, 263 (5th Cir. 2005).

provision."[57] Second, "[b]y its terms, [Section] 502(b) applies only to claims against the bankruptcy estate,"[58] and the landlord did not file a claim against the estate for lease rejection damages since it recovered its damages by drawing down on the letter of credit immediately after the tenant rejected the lease.

In the other three cases—*In re Mayan Networks*, *In re PPI Enterprises*, and *In re AB Liquidating Corp.*—the courts considered whether the landlord's draw on a tenant-provided letter of credit should be deducted from the cap or merely credited against the amount of the landlord's claim. In each case, the court relied on *Oldden v. Tonto Realty Corp.*, a 1944 decision by the Second Circuit Court of Appeals which established the pre-Code practice of deducting a security deposit draw from the cap.[59] Each court then analogized the letter of credit to a security deposit *under the facts of the case* and held that the draw should be deducted from the cap, thereby reducing the landlord's remaining unsecured claim against the estate for lease rejection damages. In *PPI Enterprises*, it is unclear whether the letter of credit was collateralized with the debtor's property.[60] The Third Circuit, however, declined to decide whether a letter of credit should receive different treatment from a security deposit "because it is clear the parties intended the letter of credit to operate as a security deposit."[61]

In both *Mayan Networks* and *AB Liquidating* the tenant-debtor had pledged cash collateral to secure its reimbursement obligation to the issuer of the letter of credit. Thus, the court in *Mayan Networks* pointed out, "[t]he draw upon the letter of credit had the same effect on the estate as the forfeiture of a cash security deposit."[62] Accordingly, the court concluded that the purposes of the cap "will be best served if the same rule is applied."[63] The court indicated, however, that its holding would not apply in the case of

57. *Id.* at 270.
58. *Id.* at 269.
59. 143 F.2d 916, 921 (2d Cir. 1944).
60. The decision indicates that the debtor had deposited fifteen million dollars of cash with the issuer, but it is unclear whether that cash collateralized the letter of credit. *In re* PPI Enter., Inc., 324 F.3d 197 (3d Cir. 2003). As pointed out by Judge Klein in *Mayan Networks*, the facts of the decision in *PPI Enterprises* "do not indicate who provided the consideration for the letter of credit that was used as a security deposit and to whom any refund would have been owed." *In re* Mayan Networks Corp., 306 B.R. 295, 311 (B.A.P. 9th Cir. 2004).
61. *PPI Enter.,* 324 F.3d at 210.
62. *Mayan Networks,* 306 B.R. at 301.
63. *Id.*

an uncollateralized letter of credit.[64] The court reasoned that an uncollateralized letter of credit is more analogous to a third party guarantee than to a security deposit, and the payments under a guaranty are not limited by the cap.

There is one unifying principle that is consistent with these four decisions as well as the language and purpose of the cap: the cap applies to claims *against the debtor-tenant* or its property for lease rejection damages by the landlord or its guarantor or indemnitor, but not to claims *by the debtor-tenant* for disgorgement. In other words, the cap may be used by the tenant as a shield, but not as a sword. Thus, as the courts have consistently held, the cap does not preclude any payment by the issuer to the landlord,[65] nor, as the court in *Stonebridge* held, does it empower the debtor-tenant to compel the landlord to disgorge any payment in excess of the cap. By contrast, as held by the court in *Mayan Networks* and *AB Liquidating Corp,* the cap should apply to (that is, be reduced by) payments under a letter of credit fully collateralized with the tenant's property. The *PPI Enterprises* court limited its decision to circumstances under which "the parties intended the letter of credit to operate as a security deposit."[66] Since a security deposit is property of the estate, such an intention would imply that the letter of credit proceeds were to be treated as property of the estate. Finally, as Judge Klein opined in his concurring opinion in *Mayan Networks*, the cap should apply to any subrogation or reimbursement claim by the letter of credit issuer against the tenant arising from the issuer's payment to the landlord. In this way, the tenant's liability is limited by the cap, and the landlord is able to secure full payment of its damages with a letter of credit. Thus, in the case of a fully collateralized letter of credit exceeding the cap but not the landlord's damages, the landlord should recover the full amount of the letter of credit proceeds in accordance with the independence principle, but the tenant should receive a refund of that portion of the collateral in excess of the cap.

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64. *Id.* at 300. In *Mayan Networks*, Judge Klein issued a lengthy concurring opinion in which he created a foundation for the holding based on an analysis of several sections of the Bankruptcy Code other than the section establishing the cap. Specifically, Judge Klein opined that the debtor's pledged funds securing the letter of credit are property of the estate under Section 541, and as such are required to be turned over to the trustee under Section 542, subject to offset under Section 553 for any claim that is not "disallowed." In other words, according to Judge Klein, the trustee is entitled to any collateral which is in excess of the cap and therefore collection by a creditor outside of the prescribed bankruptcy procedures is "disallowed."

65. *See* Norris, *supra* note 52, at 4–5.

66. *In re* PPI Enter., Inc., 324 F.3d 197, 208 (3d Cir. 2003).

In short, under this principle, tenant bankruptcy risk resides with the letter of credit issuer, who sold credit protection, rather than with the landlord, who paid for the protection.

Several commentators have questioned the applicability of the cap to the issuer's reimbursement claim.[67] However, capping the issuer's reimbursement claim is consistent with the cases applying the cap to a lease guarantor's subrogation claim against the tenant.[68] As explained by the Bankruptcy Appellate Panel for the Ninth Circuit in a decision involving the bankruptcy cap on claims of a terminated employee, standby letters of credit are "one species within the family of co-obligations that includes guarantees, sureties, and co-makers."[69] Furthermore, a co-obligor's claim for subrogation or reimbursement will be disallowed under Bankruptcy Code Section 502 (reimbursement claims) or Section 509 (subrogation claims) to the extent that the underlying claim is disallowed or limited.[70]

Section 502(e)(1) of the Bankruptcy Code provides in part that "the court shall disallow any claim for reimbursement . . . of an entity that . . . has secured the claim of a creditor, to the extent that . . . such creditor's claim against the estate is disallowed."[71] Section 502 has been liberally interpreted to apply to a broad range of claims for indemnity or reimbursement. For example, in *In re Regal Cinemas, Inc.*, Capitol assigned its interest as tenant under a lease to the debtor, as a result of which Capitol became a guarantor to the landlord of any rent not paid by the debtor.[72] The debtor agreed to indemnify Capitol for any losses under such "guaranty." When Capitol made payment under the "guaranty," it sought indemnification from the debtor. However, since the debtor had already paid the landlord the full amount allowed under the lease rejection damages cap, the Sixth Circuit Court of

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67. *See* Laura B. Bartell, *The Lease Cap and Letters of Credit: A Reply to Professor Dolan*, 120 BANKING L.J. 828, 837 (2003).

68. Note that the courts have invoked Section 509 (which applies to subrogation claims) to limit lease guarantor's subrogation claims against the tenant where the cap would so limit the landlord's claim, even if the landlord had not actually pressed its claim to the point of disallowance. *In re* Denby Stores, Inc., 86 B.R. 768, 779 (Bankr. S.D.N.Y. 1988). *See also In re* Baldwin-United Corp., 55 B.R. 885, 894 (Bankr. S.D. Ohio 1985) (noting that claims by brokers for indemnity against insurance are disallowed under 502(e)(1) because the underlying claims by the policyholders *would have been* disallowed). (Emphasis added).

69. *In re* Condor Systems, Inc., 296 B.R. 5, 15 (B.A.P. 9th Cir. 2003).

70. *See id.* at 16.

71. 11 U.S.C. § 502(e)(1).

72. *In re* Regal Cinemas, Inc., 393 F.3d 647, 649 (6th Cir. 2004). *See also In re* Baldwin-United Corp., 55 B.R. 885, 894 (Bankr. S.D. Ohio 1985).

Appeals invoked Section 502(e)(1) to deny Capitol's claim against the debtor for contractual indemnity. An issuer's right to reimbursement for payment under a letter of credit is likewise a right to indemnification for loss. Accordingly, such claim should be subject to the cap by virtue of Section 502(e)(1).

2. Structuring a Standby Letter of Credit as a Net Lease Enhancement

Given the court's emphasis in *PPI Industries* on the intentions of the parties to the lease, landlord's counsel should insert language into the lease reflecting the parties' intent that the letter of credit be treated as an independent contract (and not as a security deposit) and that the proceeds thereof not be credited against, or reduced by, the cap. In addition, when structuring a net lease transaction with a letter of credit, landlord's counsel must make provision, among other things, for the following three scenarios.

a. Tenant files bankruptcy but continues to perform under the lease.

Suppose the tenant files bankruptcy but continues to perform under the lease as it reorganizes. If the landlord has a letter of credit that allows it to draw in the event of a tenant bankruptcy, most of the courts considering this issue have permitted the landlord to draw on the letter of credit even though the tenant is in full compliance with the lease.[73] However, since the Bankruptcy Code precludes a landlord from accelerating lease payments solely as a result of a tenant bankruptcy filing, if the landlord draws down on the letter of credit there will be nothing due from the tenant to which the landlord may apply the letter of credit proceeds. As a result, the tenant's bankruptcy trustee is probably entitled to recover such funds in a suit against the landlord.[74]

Because the landlord will probably be forced to disgorge the letter of credit proceeds under these circumstances, the landlord's counsel should insist that the landlord's loan documents not require the landlord to draw

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73. First Fid. Bank v. Prime Motor Inns, Inc., 130 B.R. 610 (S.D. Fla. 1991). But see *In re* Metrobility Optical Sys. Inc., 268 B.R. 326 (Bankr. D. N.H. 2001), in which the court prohibited a draw in such situation, invoking the Bankruptcy Code's explicit invalidation of "ipso facto clauses," which are clauses that terminate or modify a lease solely as the result of the tenant's bankruptcy filing. 11 U.S.C. §§ 365(e)(1), 541(c).

74. *See In re* Builders Transp., Inc., 471 F.3d 1178 (11th Cir. 2006); *In re* OneCast Media, Inc., 439 F.3d 558 (9th Cir. 2006).

down on the letter of credit in this situation or, even worse, to use such proceeds to pay off the loan. Similarly, the CTL financing should be "soft"—that is, a tenant bankruptcy should not trigger a default under the landlord's loan documents so long as the letter of credit is in full force and effect. Otherwise, the landlord might be compelled to draw down on the letter of credit when the tenant is in full compliance with the lease, thereby potentially compromising the landlord's rights under the letter of credit, or exposing the landlord to a possible conflict between the bankruptcy court's ruling and the landlord's obligations under the loan documents.

b. Tenant files bankruptcy and fails to renew the letter of credit.

Letters of credit are generally short-term instruments of no more than one to three year's duration, whereas the financing of a long-term leaseback may have a term of twenty years or more. As a result, the landlord's lender will require assurance that it will be protected in the event the letter of credit is not renewed by the tenant's bank. One technique for covering non-renewal risk is to require that the lease payments accelerate if the letter of credit is not renewed at least thirty days before its expiration, and that such accelerated lease payments be secured by the letter of credit. So long as the tenant has paid the accelerated rent and otherwise complies with the lease terms, the tenant should retain possession of the property. In addition, the accelerated amounts should be discounted to present value. Thus, the letter of credit would be in the amount of the present value of the lease payments.

If an acceleration clause is being considered, counsel must first determine its enforceability. The American Law Institute has recognized rent acceleration clauses as an enforceable remedy: "The parties may provide in the lease that if the tenant defaults in the payment of rent or fails in some other way to perform his obligations under the lease, the total amount of rent payable during the term of the lease shall immediately become due and payable."[75]

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75. RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 12.1 cmt. k (1977). *See also* Aurora Bus. Park Assocs. v. Albert, 548 N.W.2d 153, 155 (Iowa 1996); Fifty States Mgmt. Corp. v. Pioneer Auto Parks Inc., 389 N.E.2d 113 (N.Y. 1979) (upholding acceleration of nineteen years of rent without requiring any discounting to present value). In California, the courts have held that the validity of an acceleration clause in a lease is determined by the liquidated damages statute. *See* Ricker v. Rombough, 261 P.2d 328 (Cal. App. Dep't Super. Ct. 1953) (invalidating acceleration clause under former statute); Atel Fin. Corp. v. Quaker Coal Co., 132 F. Supp. 2d 1233 (N.D. Cal. 2001); *see also* CAL. CIV. CODE § 1951.5 (1978). Under Section 1671(b) of the California Civil Code, a liquidated damages clause

The bankruptcy courts have generally enforced automatic acceleration clauses without requiring an application for relief from the automatic stay.[76]

i. Tax Consequences of Acceleration

Counsel should also consider the tax consequences of payment of accelerated rent, whether by the tenant or under the letter of credit. Since payments under a letter of credit typically receive the same tax treatment as payments under the underlying obligation,[77] the tax consequences to payment under the letter of credit will depend on the tax treatment of the tenant's payment of accelerated rent under the lease. A lease providing for prepaid rent may be considered a "Section 467 rental agreement," and therefore subject to Section 467 of the Internal Revenue Code, which requires the landlord and tenant to use the accrual method of accounting and time value of money principles for income tax purposes.[78] As long as their principal purpose is not tax avoidance, the landlord and tenant may allocate rents

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in a commercial lease is "valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made." § 1671(b). In the words of the California Supreme Court, "[a] liquidated damages clause will generally be considered unreasonable, and hence unenforceable under section 1671(b), if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach." Ridgley v. Topa Thrift & Loan Ass'n, 953 P.2d 484, 488 (Cal. 1998). To compensate the landlord for non-renewal of the letter of credit, the proposed acceleration clause requires the tenant to immediately pay the present value of the rent, and allows the tenant to stay in possession for the remainder of the lease term. Since landlord's lender is making its loan to landlord in reliance on the letter of credit, non-renewal will probably result in acceleration of the landlord's financing. Consequently, acceleration of the rents (discounted to present value) clearly bears a reasonable relationship to landlord's damages. Accordingly, although there are no cases directly on point, the proposed acceleration clause should be enforceable under California law.

76. *See In re* Stonebridge Technologies, Inc., 430 F.3d 260, 272–73 (5th Cir. 2005); *see also In re* LHD Realty Corp., 726 F.2d 327, 330 (7th Cir. 1984).

77. *See* David S. Miller, *Federal Income Tax Consequences of Guarantee: A Comprehensive Framework for Analysis*, 48 TAX LAW. 103, 130–31 (1994) (stating that the IRS has formulated a "look-through" rule whereby the beneficiary may regard a payment under a guarantee or standby letter of credit as a payment for purposes of its source, such as insurance proceeds as relating to the insured property, and that under *Putnam v. Commissioner*, 352 U.S. 82 (1956), the payment by the guarantor does not create a new obligation, but merely shifts the debtor's obligation to the guarantor); *see also* I.R.S. Gen. Couns. Mem. 38,646 (Feb. 27, 1981).

78. *See* Treas. Reg. §§ 1.467-1(a), (c) (2007).

(including accelerated rents) in the lease as they see fit.[79] Accordingly, the landlord will want the lease to allocate the prepaid rent over the entire lease term rather than the year in which it is actually paid. If the accelerated rent were allocated to the year in which it was paid, the landlord would have taxable income in that year for the full amount of the accelerated rent,[80] but no cash flow with which to pay the tax since the lender would probably require that the entire amount of the accelerated rent be applied to repayment of its loan to the landlord. If the accelerated rent is allocated over the entire lease term, then the landlord may offset a substantial portion of the rental income by deductions for imputed interest expense[81] and annual depreciation.

ii. *Effect of Acceleration on Tenant's Accounting*

Finally, the tenant will need to determine whether the acceleration clause precludes it from obtaining off-balance-sheet treatment under U.S. accounting rules. EITF 97-1 (Question 2) addresses lease remedies for defaults that are not based on tenant's failure to perform obligations customarily related to possession of the property. The EITF concluded that:

> Non-performance-related default covenants do not affect lease classification [under FAS 13] when all of the following conditions exist: (1) the default covenant provision is customary in financing arrangements, (2) the occurrence of the event of default is objectively determinable . . . , (3) pre-defined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default, and (4) it is reasonable to assume, based on the facts and circumstances that exist at the inception of the lease, that the event of default will not occur.[82]

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79. 26 U.S.C. § 467(b). However, for Federal income tax purposes, prepaid rent generally represents a loan from the tenant to the landlord for which the tenant must recognize imputed interest income and the landlord must deduct imputed interest expense. *See* Treas. Reg. §§ 1.467-2, 1.467-4.

80. Treas. Reg. § 1.467-1(c)(2)(ii)(A)(1).

81. *See* § 1.467-4.

82. Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities, EITF Abstracts, Issue No. 97-1 (1997), http://www.fasb.org/pdf/abs97-1.pdf [hereinafter EITF 97-1].

A clause accelerating rent upon the tenant's failure to obtain renewal (or replacement)[83] of a letter of credit appears to satisfy all of the above conditions with one possible exception: an argument can be made that non-renewal of the letter of credit is not "related solely to the lessee and its operations" because non-renewal could result from a collapse of the capital markets rather than from a reduction in the tenant's financial strength. However, the continued functioning of capital markets (at least at some minimum level) as well as the existence of certain basic government institutions are necessary to any U.S. company's existence and therefore must be "related to its operations." Moreover, a complete collapse of the capital markets might also affect the tenant's ability to comply with other customary lease provisions such as its obligation to maintain insurance for the property. Default penalties for the tenant's failure to insure the property are accepted as customary provisions that do not affect lease classification under FAS 13, despite the fact that default could result from a collapse of the capital markets. As a result, it appears that an acceleration clause for non-renewal of a letter of credit should not affect lease classification under FAS 13.

The task force also considered whether a nonperformance-related default covenant would violate the continuing involvement criteria in FAS 98 and wrote:

> Regardless of whether the above conditions exist, if the lease is part of a sale-leaseback transaction that is subject to the provisions of [FAS] 98, a default remedy that allows the buyer-lessor to put the leased property to the seller-lessee would violate the continuing involvement criteria in [FAS] 98 and, therefore, the transaction would be [on-balance-sheet].[84]

Although not explicitly addressed by the task force, it is reasonable to conclude that a default remedy should not preclude sale-leaseback accounting under FAS 98, so long as it does not allow the buyer-landlord to put the lease property to the seller-tenant. Since a typical acceleration clause will not allow

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83. In the event of non-renewal of the letter of credit by the tenant's bank, the tenant should be permitted to obtain a replacement letter of credit issued by another bank with a sufficiently strong credit rating.

84. EITF 97-1, *supra* note 82.

the landlord to put the property to the tenant, it should not preclude off-balance-sheet treatment under FAS 98.

c. Tenant files bankruptcy and defaults under the lease after (or shortly before) filing.

Large companies will rarely default on a significant lease obligation unless they have filed, or are about to file, for bankruptcy. Thus, in *Stonebridge Technologies* the tenant filed bankruptcy shortly after defaulting on the lease.[85] The landlord in that case was able to retain the full amount of the letter of credit proceeds because the lease provided for acceleration of rents upon default.[86] Without this acceleration clause, the landlord could still have drawn down the full amount of the letter of credit as a result of the independence principle. However, the tenant could then have compelled the landlord to disgorge any proceeds in excess of past due rent.[87] Note that the tenant's claim for disgorgement would be predicated not on application of the cap, but on the tenant's contractual rights under the lease and its related equitable rights to prevent the landlord's undue enrichment. Accordingly, landlord's counsel should insist on a lease clause automatically accelerating rent following any significant rental delinquency.

In short, a properly structured letter of credit provides effective credit enhancement to a landlord in the event of a tenant bankruptcy.

D. Lease Bonds and Mortgage Insurance

A lease bond is a credit instrument whereby a surety guarantees the tenant's obligations under a lease for the benefit of the landlord.[88] The surety's obligations under the lease bond are limited to the dollar amount stated in the bond. Under New York state insurance law, a lease bond may only be written by a company licensed as a financial guaranty insurer.[89] As a

85. *In re* Stonebridge Technologies, Inc., 430 F.3d 260, 264 (5th Cir. 2005).
86. *Id.* at 273.
87. *See In re* Builders Transp., Inc., 471 F.3d 1178, 1181 (11th Cir. 2006); *In re* OneCast Media, Inc., 439 F.3d 558, 561 (9th Cir. 2006).
88. *See* James R. Stillman, *Counseling the Letter of Credit Arranger on Tenant Insolvency*, 17 NO. 6 PRAC. REAL EST. LAW. 45, 51–54 (2001).
89. Opinion of the N.Y. Office of General Counsel, (Apr. 27, 2004) http://www.ins.state.ny.us/ogco2004/rg040425.htm.

type of surety bond, a lease bond is legally equivalent to a guaranty,[90] however, the terms "lease bond" and "surety bond" are applied to guaranties issued by companies in the business of issuing such obligations. Thus, lease bonds receive the same treatment in a tenant bankruptcy as do lease guaranties.[91]

While lease bonds may be useful for certain commercial leases, they rarely make sense in a net lease transaction. As discussed below, a lease bond is less desirable than either (1) a letter of credit, due to the letter of credit's superior liquidity, or (2) mortgage insurance, due to the dramatically lower premium attached to mortgage insurance.

1. Lease Bond v. Letter of Credit

A lease bond—which is a type of surety bond—is not as easily liquidated as a standby letter of credit. Unlike the issuing bank's independent obligation under a letter of credit, a surety's liability is secondary to the liability of the principal for the obligation.[92] As a precondition to receiving payments on its claim, the beneficiary under a surety bond must prove the existence of a default on the underlying lease or other contract. Meeting this burden to the satisfaction of the surety generally results in some delay in payment and may lead to litigation.[93] By contrast, the issuing bank's obligation under a standby letter of credit is primary: the bank must pay the beneficiary promptly upon the presentation of a certificate of nonperformance.[94] If the beneficiary's certificate of nonperformance is incorrect, and the tenant can disprove any alleged default, the tenant may sue the beneficiary for any overpayment, but cannot prevent the issuing bank from making such payment in the first place.[95] Moreover, the beneficiary holds such payment during any litigation brought by the tenant. In short, a letter of credit is a liquid instrument which allocates the cost of delay in payment from contract disputes to the issuing bank and the applicant, while the lease bond is a relatively illiquid instrument which allocates such cost to the beneficiary.

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90. *See* Robert D. Aicher, Deborah L. Cotton & TK Khan, *Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)*, 59 BUS. LAW. 897 (2004).
91. *See* 2 NORTON BANKR. L. & PRAC. 3d § 43:7 (2008).
92. W. Sec. Bank v. Superior Court, 933 P.2d 507, 516 (Cal. 1997).
93. *See generally* Dolan, *supra* note 46, ¶ 1.05.
94. *Id.*
95. *Id.*

2. Lease Bond v. Mortgage Insurance

Landlords seeking credit support in net lease transactions often do so to reduce their cost of capital. In a net lease to a credit tenant, the tenant's lease constant (that is, the ratio of its annual rent to the value of the premises) is typically a function of the landlord's cost of capital. As a result, providing the landlord with effective credit support of the tenant's lease obligations will generally benefit the tenant in the form of lower rent. The most direct way to provide effective credit support for the benefit of the landlord's lender is to insure the mortgage payments themselves.

Under New York insurance law, as is the case with lease bonds, insurance of commercial mortgages may only be issued by companies licensed by the state as financial guaranty insurers.[96] Although financial guarantee insurance companies are authorized to insure commercial mortgages, their primary business is insuring municipal bonds and asset backed securities.[97] Under municipal bond insurance, the insurer is typically obligated to make a principal or interest payment upon demand of the bond trustee. Upon receipt of such payment, the bondholders are required to assign to the insurer either the right to any interest payment made by the trustee, or the entire bond itself in the event the trustee has repaid the entire principal balance.[98] Commercial mortgage policies typically follow the same structure.[99]

Mortgage insurance differs from a lease bond in at least two important ways. First, the beneficiary under a lease bond is typically the landlord while the beneficiary (or insured) under a policy of commercial mortgage insurance is the landlord's lender. Second, upon payment under a lease bond the surety has a subrogation claim against the tenant only, rather than against the property. By contrast, upon payment under a policy of commercial mortgage insurance, the insurer is typically assigned the mortgage documents, giving it recourse against both the property and the tenant. From the landlord's

96. N.Y. INS. LAW § 6904(a) (McKinney 2004); N.Y. INS. LAW § 6901(a)(1), (b) (McKinney 2005). Under New York law, residential mortgage insurance (commonly known as private mortgage insurance) is written by companies known as mortgage guaranty insurance companies under a different license. N.Y. INS. LAW § 6503 (McKinney 2008). Mortgage guaranty insurance companies are not authorized to insure commercial mortgages. *Id.*

97. *See generally* Assoc. of Fin. Guar. Insurers, Investors' Frequently Asked Questions, http://www.afgi.org/invest_faq.htm. In recent years, over half of all new U.S. municipal bonds have carried financial guarantee insurance. *Id.*

98. Michael E. Satz, *Municipal Bond Insurance*, 262 PLI/REAL 157 (June 1985) (discussing bond insurance generally and providing a specimen AMBAC Municipal Bond Insurance Policy).

99. *See* Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783, 799 (2004).

standpoint, the lease bond has an advantage over commercial mortgage insurance in that payment under the mortgage insurance policy results in a claim against the landlord's property while payment under the lease bond does not. This advantage, however, comes with a higher price tag for the lease bond which will likely be unacceptable to a landlord focused on reducing its cost of capital.

Because of the structural differences between a lease bond and a policy of commercial mortgage insurance, the lease bond surety is subject to considerably greater risk, which is likely to be reflected in a substantially higher premium as compared to commercial mortgage insurance. Consider first the risk facing the issuer of a lease bond. In the event of a lease default, the issuer must pay the landlord's damages up to the amount of the bond. The insurer is then subrogated to the rights of the landlord and may pursue the tenant for reimbursement, but the tenant will likely have filed bankruptcy and the insurer's claim will be limited by the lease rejection damages cap. By contrast, the insurer of a mortgage on a properly structured net leased property is not subject to any significant default risks other than a lease default,[100] but has additional avenues of risk mitigation or recovery. As the assignee of the mortgage documents, the insurer of a commercial mortgage on net leased property may look not only to the tenant but also to the property collateralizing the loan. In addition, although commercial mortgage loans are frequently nonrecourse to the borrower, the borrower may wish to use its own money to cure its mortgage default to protect its interest in the property as well as its credit rating. In short, commercial mortgage insurance of net leased property, if available, is likely to be substantially less expensive than insuring the tenant's rental payments through a lease bond.

IV. NONTRADITIONAL CREDIT ENHANCEMENTS

A. Credit Default Swaps

Under a credit default swap (CDS), a financial institution or insurance company is paid to bear a credit risk by an investor or other financial institution which most likely had no exposure to such credit risk in the first place. Essentially, a CDS is a bet over whether a borrower will repay a debt. CDSs are issued to cover default risks on a variety of obligations: a particular obligation of a designated corporation (called a "single name CDS"); a

100. *See* discussion *infra* Section IV.A.2.

tranche in a CMBS, a residential mortgage backed security (RMBS), or collateralized debt obligation; a syndicated secured loan; or a basket of certain of these obligations. This article considers the use of a single name CDS in a net lease transaction.

Once lauded as the "debutante of the suretyship world (pure as the wind-driven snow and virtually unsullied by the foul touch of litigation),"[101] the CDS market has recently faced condemnation as a cause of the recent credit crunch.[102] However, the blame appears to be directed primarily at the CDS backing CDOs and securitized mortgages.[103] Furthermore, the critics have generally called for more regulation or for a change in accounting treatment and not a wholesale elimination of the CDS market.

CDSs were introduced in the early-1990s.[104] After the completion of certain regulatory accommodations in 2000,[105] CDS experienced explosive

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101. Aicher, *supra* note 90, at 898.

102. *See, e.g.*, Jesse Eisinger, *The $58 Trillion Elephant in the Room*, CONDÉ NAST PORTFOLIO, Oct. 15, 2008.

103. *See, e.g.*, Carrick Mollenkamp, Serena Ng, Liam Pleven & Randall Smith, *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test,* WALL ST. J., Nov. 3, 2008, at A1.

104. Jongho Kim, Ph.D., *From Vanilla Swaps to Exotic Credit Derivatives; How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 709 (2008).

105. In 1990, Section 560 was added to the Bankruptcy Code to give swap participants the right to terminate a swap agreement and to net out termination amounts and payments under such swap without being subject to either the automatic stay provision or the ipso facto provision of Section 365(e)(1) of the Code. The Commodity Futures Modernization Act of 2000 both amended the Federal securities laws to exclude swap agreements from regulation as a security, while keeping swap agreements covering a security subject to the SEC's insider-trading rules, and excluded credit default swaps from regulation under the Commodity Exchange Act. *See* David Yeres, *An Overview of the Uses of and Issues Surrounding Credit Derivatives*, 1589 PLI/CORP 529, 555–61 (2007) [hereinafter Yeres]. In 2000, the New York Insurance Department issued a nonbinding opinion stating that derivatives that do not require a party to sustain actual losses are not insurance contracts. Opinion of the N.Y. Office of General Counsel, (Feb. 15, 2000) http://www.ins.state.ny.us/ogco2000/rg000205.htm. In 2004, the New York Department of Insurance enacted an amendment to New York's insurance laws making clear that credit default swaps were not insurance. N.Y. INS. LAW § 6901(j-1) (McKinney 2005). By contrast, the NAIC has taken the position that state insurance regulators *should* be able to regulate credit default swaps because they transfer risk from one entity to another for a fee. Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 186 (2007) [hereinafter Schwartz]. However, one commentator suggests that credit default swaps are not insurance contracts because only those with "insurable interests" may enter into insurance contracts, and insurance contracts are personal so therefore nontransferable, whereas credit default swaps are transferable and do not require an "insurable interest." *Id.*

growth. According to the International Swaps and Derivatives Association, Inc. ("ISDA"), the outstanding notional amount of CDSs totaled $54.6 trillion in the first half of 2008[106]—nearly four times the U.S. gross national product. Although the outstanding notional amount of CDSs has been cut in half over the past year[107], over three quarters of a trillion dollars in CDSs continues to be issued each week.[108]

CDSs are traded entirely over the counter, and current price quotations may be quickly obtained by a broker over the telephone. Over ninety percent of CDSs traded worldwide are settled electronically.[109] The vast majority of CDSs are drawn on standardized documents created by ISDA.[110] Under the ISDA documentation[111] for a single name CDS, the protection buyer pays the protection seller a fixed amount in return for the protection seller's promise to pay a calculated amount upon the bankruptcy (or other "credit event") of the "reference entity."[112] The formula for calculating the protection seller's payment depends on the type of settlement method selected by the parties: cash settlement or physical settlement.

Under cash settlement, following a credit event, the protection seller makes a one time cash payment representing the decrease in market value of the insured obligation called the "reference obligation."[113] In some cash settlement CDSs, the buyer is permitted to select at settlement an obligation of the reference entity other than the reference obligation for purposes of calculating the settlement payment. Interestingly, cash settlement is rarely used in the single name CDS market.[114]

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106. *See* ISDA, News Release, ISDA Mid-Year 2008 Survey Shows Credit Derivatives at $54.6 Trillion (Sept. 24, 2008), http://www.isda.org/press/press092508.html.
107. *See* DEPOSIT TRUST & CLEARING CORP., Trade Information Warehouse Data for week ending March 13, 2009, Table 1, http://www.dtcc.com/products/derivserv/data_table_i.php.
108. *Id.* at Table 17, http://www.dtcc.com/products/derivserv/data_table_iii.php.
109. *See* DEPOSIT TRUST & CLEARING CORP., DERIV/SERV: DELIVERING AUTOMATED SOLUTIONS AND RISK MANAGEMENT TO OTC DERIVATIVES 1 (2008), http://www.dtcc.com/downloads/brochures/derivserv/DerivSERV_Brochure.pdf.
110. Schwartz, *supra* note 105, at 171.
111. The ISDA documentation for CDS consists of the 2003 ISDA Credit Derivatives Definitions [hereinafter ISDA Credit Definitions], the ISDA Master Agreement, and the Confirmation (a form which is attached to the ISDA Credit Definitions). The ISDA Credit Definitions and the ISDA Master Agreement are available for a fee through http://www.isda.org (on file with the Virginia Law & Business Review).
112. *See generally* ISDA Credit Definitions, *supra* note 111.
113. *See id.* §§ 7.1–7.4.
114. *See* ROBERT E. WHALEY, DERIVATIVES: MARKETS, VALUATION, AND RISK MANAGEMENT 11–18 (2006).

In the case of a physical settlement, upon a credit event the protection buyer physically delivers to the protection seller the reference obligation or another specified type of obligation of the reference entity with the same principal balance. An obligation (including the reference obligation) which satisfies the protection buyer's delivery obligation under the CDS is called a "deliverable obligation."[115] Upon receipt of the deliverable obligation, the protection seller must pay the principal balance of the reference obligation to the protection buyer.[116]

In practice, the protection buyer rarely holds the reference obligation.[117] However, because of the massive size of the CDS market, the notional amount of the outstanding CDSs for any large corporation will likely exceed the value of the debt issued by such corporation.[118] As a result, the protection buyer may be forced to pay a distorted price for a deliverable obligation in order to satisfy its obligations under the CDS. To avoid this problem, ISDA and a number of leading dealers in the credit derivative market have developed protocols for orderly auctions of obligations of some reference entities.[119] Under such protocols, the final price of the deliverable obligation that the protection seller must pay the protection buyer is determined by auction. The CDS is then cash settled based upon that determination, notwithstanding that physical settlement was specified in the CDS.[120] Before March 12, 2009, these protocols were issued on a case-by-case basis and applied only to a CDS when the parties expressly opted in. As of that date, these protocols were "hardwired" into the 2003 ISDA Credit Derivatives Definitions and apply to CDS transactions entered into after that

115. *See* ISDA Credit Definitions, *supra* note 111, §§ 2.15, 8.1. In a plain vanilla CDS, a Deliverable Obligation must be a "Bond" or "Loan" with the following eight characteristics known as the "great eight": Not Subordinated, Specified Currency: Standard Specified Currency, Not Contingent, Assignable Loan, Consent Required Loan, Transferable, Maximum Maturity 30 Years, and Not Bearer.

116. *See* ISDA Credit Definitions, *supra* note 111, §§ 8.1–8.5.

117. *See generally* VINOD KOTHARI, *Introduction to Credit Derivatives*, *in* CREDIT DERIVATIVES AND SYNTHETIC SECURITISATION (2002), http://www.credit-deriv.com/introduction to credit derivatives article by Vinod Kothari.pdf.

118. *See* Yeres, *supra* note 105, at 538.

119. *Id.* Reference Entities that have been subject to these protocols have included Delphi Corp., Calpine Corp., Quebecor World Inc., Delta Air Lines Inc., and Northwest Airlines Inc. *Id.*

120. *Id.* For an example of such a protocol, see ISDA, Plain English Summary of the Auction Methodology in the 2008 Quebecor CDS Protocol (2008), http://www.isda.org/2008quebecorcdsprot/docs/Quebecor-Protocol-Plain-English-Summary.pdf.

date to the extent the relevant confirmation incorporates the March 2009 supplement.[121]

The CDS counterparties may choose to specify the economic terms of the transaction as they see fit. However, premiums are determined by factors such as the creditworthiness of the reference entity and the protection seller, the expected recovery rate of the principal if a credit event occurs, the conditions in the financial markets, and the tradability of the CDS in the OTC markets.[122] "Vanilla" CDSs are those with economic terms common across most other CDSs.[123] Vanilla CDSs are the most tradable in the OTC market and therefore come with the lowest premium for the protection buyer.

In a vanilla CDS, the reference obligation is either a corporate bond or a loan issued by the reference entity, and the settlement method is physical. There are several possible credit events that the counterparties may choose in the confirmation.[124] In a vanilla CDS, the credit events are bankruptcy, failure to pay, and restructuring.[125] The definitions of failure to pay and restructuring both include a materiality condition that states that the impaired portion of payment (or the amount of debt being restructured) must exceed a specific amount in order to constitute a credit event.[126] Both failure to pay and restructuring are triggered by a broader category of obligations than the reference obligation. The counterparties choose one category of obligation in

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121. 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions (Mar. 12, 2009), http://www.isda.org/companies/auctionhardwiring/docs/Supplement-CLEAN.doc.

122. *See* MOORAD CHOUDHRY, STRUCTURED CREDIT PRODUCTS: CREDIT DERIVATIVES AND SYNTHETIC SECURITIZATIONS 5–10 (2004).

123. *See generally* ANTULIO N. BOMFIM, UNDERSTANDING CREDIT DERIVATIVES AND RELATED INSTRUMENTS 286 (2005).

124. Possible credit events include bankruptcy, failure to pay, obligation acceleration (rarely used), obligation default (rarely used), repudiation/moratorium (used only with sovereign indebtedness such as government bonds), and restructuring. *See* Yeres, *supra* note 105, at 538.

125. Kim, *supra* note 104, at 756. To constitute a credit event, a restructuring must: (a) be binding on all holders, (b) result from credit deterioration of the reference entity, (c) not be provided for under the obligation's original terms, and (d) the obligation must be held by more than three unrelated entities and the obligation must require consent to the restructuring by at least two-thirds of the holders. *See* ISDA Credit Definitions, *supra* note 111, §§ 4.7, 4.9.

126. *See* Jeffrey S. Tolk, Understanding the Risks of Credit Default Swaps 6–9 (Mar. 16, 2001), http://www.securitization.net/pdf/MoodySyntheticCDORisks.pdf. Pursuant to a convention known as "Mod R," vanilla CDSs in North America limit the terms of deliverable obligations to those which are fully transferable with a specified limit on the final maturity date. *See* ISDA Credit Definitions, *supra* note 111, § 2.32.

the confirmation, as to which the failure to pay or restructuring would constitute a credit event: in a vanilla CDS, the choice is "borrowed money,"[127] which is defined as "any obligation . . . for the payment or repayment of borrowed money."[128]

Landlords seeking to hedge the risk of a tenant default or bankruptcy in a large net lease transaction should consider purchasing a CDS in which the reference entity is the tenant or the lease guarantor. In the event of a tenant bankruptcy, the protection seller under a CDS would have no claim against the tenant or its property, except that in the case of physical settlement the protection seller would have a claim under the deliverable obligation transferred to the protection seller. As a result, any payment under the CDS would clearly be free of the automatic stay as well as the lease rejection damages cap, and such payment would not be credited against the cap or subject to disgorgement by the tenant.[129] Because the tenant (as the reference entity) would have no obligation or rights under the CDS, the landlord's purchase of a CDS covering the tenant would not preclude off-balance-sheet treatment of the tenant's lease or sale-leaseback under U.S. accounting rules.

In the case of most CDSs, both the protection buyer and the protection seller must account for the CDS with mark-to-market accounting under FAS 133. Under mark-to-market accounting, the CDSs are reported on the balance sheet as assets or liabilities at their fair value, and any changes in fair value must be recognized currently in earnings.[130]

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127. Kim, *supra* note 104, at 767. Commentators suggest that the category of Payment is too broad, Reference Obligations Only is too narrow, Bond is too narrow, Loan is too narrow, and Bond or Loan is too narrow. *See* Donald Bendernagel et al., *Credit Derivatives: Usage, Practice and Issues*, 1632 PLI/CORP 347, 408 (2007).

128. ISDA Credit Definitions, *supra* note 111, § 2.19(a)(ii).

129. *See supra* notes 61–67 and accompanying text.

130. Accounting for Derivative Instruments and Hedging Activities, Statement of Financial Accounting Standards No. 133, ¶ 18a (FASB 1998), http://www.fasb.org/pdf/fas133.pdf [hereinafter FAS 133]. Note that if the CDS qualifies for hedge accounting, then

> (1) the change in value of an existing hedged item ascribable to credit risk is also marked to market through the income statement or (2) the change in the value of the CDS is included in a component of shareholder equity (until the forecasted transaction affects earnings) if the CDS hedges the credit risk of a forecasted transaction.

New York State Society of Certified Public Accountants, Statement on Credit Default Swaps Provided in Response to IRS Notice 2004-52 10 (2005), http://www.nysscpa.org/commentletter/swap.pdf. However, most CDS counterparties do not use hedge accounting. *Id.*

1. Using a Vanilla Credit Default Swap to Enhance the Credit of a Tenant

In a vanilla CDS, the reference entity must be listed on the reference entity Database (RED) as published by Markit,[131] and would therefore need to be a publicly traded company. Thus, to hedge with a vanilla CDS, either the tenant or lease guarantor must be publicly traded.[132] The reference obligation in a vanilla CDS would be a bond or loan of the reference entity. The RED also lists the preferred reference obligation of each qualifying reference entity. The preferred reference obligation is the default reference obligation for CDS trades.

In a vanilla CDS, the settlement method is physical. However, the landlord need not own and hold the reference obligation or equivalent deliverable obligation, because the new protocols for physical settlement effectively transform physical settlement into a cash settlement.

A vanilla CDS lists borrowed money as the obligation category;[133] a lease is not borrowed money.[134] As a result, the tenant's failure to make lease payments under a vanilla CDS will not trigger a credit event. In practice, however, a publicly traded company is unlikely to default on a lease without

131. *See* Markit, Markit RED CDS, http://markit.com/information/products/red_cds.html.

132. If the tenant is not a publicly traded company listed on the Reference Entity Database, but its parent or other affiliate is, the landlord may consider using the tenant's parent or other affiliate as the reference entity on the theory that publicly traded companies often will file a consolidated bankruptcy if one of their subsidiaries fails. Of course, with this option the tenant could default on the lease or other obligation, as well as file for bankruptcy, and not trigger a credit event under the CDS because the parent or affiliate is the reference entity. It may be possible that a bankruptcy court would substantively consolidate the indebtedness of both the parent and the tenant so that the economic effect would be that the two separate entities are treated as one. Such substantive consolidation is permissible under the bankruptcy court's general equitable powers pursuant to Section 105(a) of the Bankruptcy Code. 11 U.S.C. § 105(a). However, even if the tenant filed for bankruptcy, and even if the bankruptcy court substantively consolidated the tenant and its corporate parent, the protection seller may not have to recognize the substantive consolidation because the plain terms of the CDS require the bankruptcy of the reference entity, independent of a bankruptcy court's decision, to substantively consolidate the tenant and its corporate parent.

133. *See* Yeres, *supra* note 105, at 538 (discussing other possible choices for obligation categories).

134. The 2003 ISDA Credit Derivative Definitions define Borrowed Money as "any obligation (excluding an obligation under a revolving credit arrangement for which there are no outstanding, unpaid drawings in respect of principal) for the payment or repayment of borrowed money (which term shall include, without limitation, deposits and reimbursement obligations arising from drawings pursuant to letters of credit)." ISDA Credit Definitions, *supra* note 111, § 2.19(a)(ii).

filing for bankruptcy either before or shortly after the default, and a bankruptcy filing is a credit event under a vanilla CDS.

The biggest obstacle to the use of a vanilla CDS as a hedge against tenant default arises from the mismatch between the bankruptcy treatment of corporate bonds compared to the bankruptcy treatment of leases. Unlike landlords, corporate bondholders are often secured creditors, and their claims are not subject to any cap under the Bankruptcy Code. Furthermore, an issuer may file bankruptcy in order to terminate its leases or adjust other debts which are subject to treatment favorable to the debtor under the Bankruptcy Code while it has adequate income and capital to meet its other obligations. As a result, a tenant can file for bankruptcy and reject one or more leases while suffering very little diminution in the value of its senior bonds. In fact, Kmart Corp. filed a Chapter 11 bankruptcy in January of 2002 and rejected many of its leases while experiencing only a modest reduction in the trading price of its bonds.[135] As discussed above, if the tenant files for bankruptcy and rejects the lease, the landlord will have an unsecured claim for future lost rents subject to the lease rejection damages cap. As a result, a tenant bankruptcy could result in a large loss to the landlord with little or no recovery under the CDS. By contrast, if the tenant assumed the lease in question and its senior debt was unsecured or under-secured, the landlord might suffer no loss on its lease but a significant recovery under the CDS.

In short, a vanilla CDS is at best a mediocre hedge against a tenant default or bankruptcy, but one which may be attractive based on pricing and investment returns.

2. Using an Exotic Credit Default Swap to Enhance the Credit of a Tenant

Landlords willing to pay a significantly higher fee for a better hedge against tenant default should consider using an exotic CDS, which is referred to in this article as a "Net Lease CDS." As in a vanilla CDS, a Net Lease CDS would designate the tenant or lease guarantor as the reference entity and the preferred reference obligation in the Markit RED as the reference obligation. However, a Net Lease CDS would make three basic changes to the vanilla swap. First, the Net Lease CDS would broaden the category of

135. Kmart was able to secure $2 billion in debtor financing in order to pay back $1.6 billion in pre-petition debt. *Kmart Files Chapter 11: Struggling Discount Retailer Ends Speculation, Files for Bankruptcy Protection*, CNN MONEY, Jan. 2, 2002, http://money.cnn.com/2002/01/22/companies/kmart/.

obligation as to which a failure to pay triggered a credit event. As discussed above, a vanilla CDS uses borrowed money—which excludes leases—as the applicable category; the Net Lease CDS would use "payment"—which includes leases[136]—as the applicable category. As a result, under the Net Lease CDS, a monetary lease default above the negotiated threshold would trigger a credit event and therefore payment under the CDS. Second, the Net Lease CDS would use cash settlement rather than physical settlement. Third, the Net Lease CDS would calculate the cash settlement amount independently of the loss on the reference obligation. Instead, the formula for calculating the cash settlement amount will depend upon whether the CTL is hard or soft. If the CTL is hard—meaning a tenant default or bankruptcy puts the landlord's CTL financing into default—then upon tenant default or bankruptcy the landlord would likely be required to repay the entire loan balance plus any applicable pre-payment penalty. Accordingly, the cash settlement amount for a net lease financed with a hard CTL would be equal to the scheduled amortized loan balance at the time of default plus an amount equal to the prepayment penalty using the formula prescribed by the CTL loan documents. Since the formula for a typical prepayment penalty is based on (i) the interest rate of a treasury bill with a remaining term matching the remaining loan term, (ii) the remaining scheduled loan payments, and (iii) a fixed discount rate, the prepayment penalty may be easily and quickly calculated.

In short, under the Net Lease CDS, upon a tenant bankruptcy or material default, the protection seller would be required to pay an amount sufficient to pay off the landlord's loan including any applicable pre-payment penalty. This CDS would not be a perfect hedge because the landlord would continue to own the leased property free and clear after payment under the CDS. In other words, the landlord would be paid an amount greater than its economic loss from a tenant default or bankruptcy.[137]

If the CTL is soft—meaning that neither a tenant default nor tenant bankruptcy puts the landlord's CTL financing into default, the cash settlement amount in a Net Lease CDS would be equal to the present value

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136. *See* ISDA Credit Definitions, *supra* note 111, §§ 2.19(a)(i)–(ii).

137. The payment under the CDS would likely be treated as ordinary income since the Net Lease CDS is in the form of a guaranty, and payment under a guaranty is generally treated in the same manner as a payment under the guaranteed obligation. *See* Bruce E. Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, 792 PLI/TAX 573, 592 (2007). Similarly, the cost of the CDS would likely be treated as a guarantee fee and therefore an ordinary deduction. *Id.* at 627.

(based on an agreed discount rate) of the difference between the scheduled rent under the lease and the fair market rent at the time of the credit event. This formula would roughly approximate the landlord's losses under the lease. To avoid litigation over the determination of the fair market rent under the lease, the confirmation should either designate a valuation agent to serve as the agreed-upon appraiser for this purpose, or set forth a formula based on a published index of commercial rent rates in the region where the leased property is located. A CDS using this formula would be time consuming to negotiate given the difficulty of quickly and fairly determining market rent, but it would effectively hedge tenant credit risk.

B. Wells Fargo's Proprietary "Lease Receivables Protection"

As of the writing of this article, Wells Fargo Bank has made available to its clients a proprietary instrument called "Lease Receivables Protection," which provides credit protection to landlords under eligible commercial leases.[138] A landlord purchasing Lease Receivables Protection pays an upfront one-time fee to Wells Fargo in return for protection over a specified term of up to five years. In return, if a tenant files bankruptcy and rejects the lease, the landlord may sell eligible lease receivables claims to Wells Fargo for an amount equal to the unpaid and accrued rentals multiplied by an agreed percentage. The agreed percentage is set at the time of the landlord's purchase of the Lease Receivables Protection. If there is no tenant bankruptcy filed or if the tenant files bankruptcy and assumes the lease, the Lease Receivables Protection expires with no further payments and without value.

Since this instrument is not collateralized with the tenant's assets, in the event of a tenant bankruptcy any payment by Wells Fargo to the landlord would clearly be free of the automatic stay as well as the lease rejection damages cap, and such payment would not be credited against the cap or subject to disgorgement by the tenant.[139] In addition, because payment under this instrument is based on unpaid rentals rather than loss in value of the tenant's senior bond, it appears to be a better hedge against tenant default than a plain vanilla CDS. Finally, this instrument appears to fall under the exemption from mark-to-market accounting for qualifying "financial

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138. *See* Wells Fargo, Lease Receivables Protection: Credit Risk Hedging (2007) (on file with the Virginia Law & Business Review).

139. *See supra* Section III.C.1.

guarantee contracts" under FAS 133.[140] Accordingly, while the protection buyer of a vanilla CDS is typically required to use mark-to-market accounting under U.S. accounting rules, it appears that the buyer of Lease Receivables Protection is not.

Counsel for a landlord considering the purchase of this instrument should address the following issues, among others. First, since this instrument does not provide for payment of future rents it probably would not provide the landlord with sufficient funds to pay off a CTL financing should the tenant's bankruptcy result in acceleration of the landlord's CTL. Accordingly, if the landlord purchases this instrument for credit enhancement, landlord's counsel should insist that landlord's CTL financing be soft—that is, that so long as the Lease Receivables Protection is in place, neither a tenant bankruptcy nor lease default triggers an event of default under the CTL financing. Second, landlord's counsel should explore the scope of the landlord's duty to mitigate under this instrument. Finally, landlord's counsel will need to address the consequences of a tenant lease assumption followed by a lease rejection under the terms of this instrument.

CONCLUSION

Landlords seeking to enhance their tenants' credit have a wide range of instruments available to them. In net lease transactions, cash security deposits are rarely used because they have adverse economic and accounting consequences for the tenant and are of limited benefit to a landlord in a tenant bankruptcy. A lease guarantee from the tenant's parent avoids all the disadvantages of a cash security deposit and accordingly is the most commonly used tenant credit enhancement. However, by definition parent guarantees do not provide a separate repayment source outside the tenant's consolidated group, and they are of limited benefit to the landlord if the parent files bankruptcy.

Credit support instruments from third parties include letters of credit, lease bonds, mortgage insurance, and credit default swaps. Among these instruments, a letter of credit, if available, is likely to provide the most effective and economical credit support for a long term net lease. As a practical matter, however, a tenant whose credit is unsatisfactory to the landlord or its lender may be hard pressed to obtain an uncollateralized letter of credit. Such a tenant may be unable or unwilling to post the required

140. FAS 133, *supra* note 130, ¶ 10d.

collateral; in the case of an off-balance-sheet sale-leaseback, it is precluded from doing so by U.S. accounting rules. In such events, if the tenant or its parent is a public company, the landlord should consider purchasing a credit default swap.

Plain vanilla CDSs are typically priced over the telephone, and most are purchased and settled electronically. However, a plain vanilla swap is only a mediocre hedge against tenant credit risk. This article suggests the use of an exotic credit default swap (called a Net Lease CDS) which will effectively hedge tenant credit risk but at a substantially higher price than that of a vanilla swap. Wells Fargo Bank's proprietary "Lease Receivables Protection" also provides a hedge which is clearly superior to that of a vanilla swap. While the Wells Fargo product is unlikely to be as effective a hedge as the Net Lease CDS, it is likely to be significantly less expensive.

The ideal tenant credit enhancement will of course depend on the tenant's particular circumstances and may turn out to consist of a combination of financial instruments or perhaps a completely new product inspired by the necessities of the current financial meltdown.