



DECISION PRESERVES SECURITY OF LETTER OF CREDIT IN INSOLVENCY PROCEEDINGS

By: Colleen Kelly
Liebmann, Conway, Olejniczak & Jerry, S.C.
E-Mail: cmk@lcojlaw.com

A recent Wisconsin Supreme Court case examines the treatment of letters of credit in proceedings commenced under Wis. Stat. ch. 128, Wisconsin's receivership statute. This decision is especially relevant for landlords secured by a letter of credit, and banks that issue letters of credit. It recognizes that the "independence principle" protects a letter of credit beneficiary's contractual right to draw on a letter of credit, even in the event of a bankruptcy filing.

A letter of credit forms three contracts between the issuer, beneficiary, and applicant, each of which support the other, but the obligations for each transaction are separate. In other words, the duty of the issuer to the beneficiary is independent of the beneficiary's duty to the applicant for the letter of credit, or such applicant's duty to the issuer. The independence principle provides that an issuer must pay upon proper presentation. As the Wisconsin Supreme Court acknowledges, standby letters of credit have been historically used in commercial transactions because they "shift the risk of nonpayment and insolvency from the beneficiary to the issuer of the letter of credit." (¶ 35).

In 2004, 700 Stanton Drive, LLC ("Stanton") purchased an industrial building from Admanco for \$2.5 million. Stanton leased the building back to Admanco, which paid Stanton a security deposit of \$61,313.66. As additional security, Admanco provided two irrevocable standby letters of credit, each for \$375,000, for Stanton's benefit as part of the 15-year lease agreement. The bank, secured by Admanco's property, issued the letters of credit, both of which were payable in the event of nonpayment of rent.

On December 30, 2004, Admanco filed an assignment for the benefit of creditors pursuant to ch. 128, and a receiver was appointed. Admanco breached the lease shortly after the receivership was commenced by failing to make its January 1, 2005 rent payment. Admanco did not cure the breach despite receiving the requisite notice and opportunity from Stanton. On January 10, 2005, in the face of Admanco's default, Stanton presented the appropriate documents to the bank and drew down \$750,000 on both letters of credit. Stanton also retained Admanco's entire security deposit.

The receiver remained in possession of the premises leased from Stanton until the court approved his sale of Admanco's assets to EBSCO Industries in January of 2005. EBSCO assumed possession of the leased premises and entered into a new written lease with Stanton which began on April 1, 2005. The bank received \$3 million dollars from the sale proceeds, \$750,000 of which was used to reimburse it for issuing the letters of credit.

The receiver filed suit against Stanton claiming \$811,313.66 on behalf of the Admanco estate. This amount included the \$750,000 drawdown on the letters of credit and the \$61,313.66 security deposit. The receiver took the position that (1) Stanton drew down more proceeds than

it was contractually entitled to receive under the lease and (2) that the proceeds of the standby letters of credit became subject to his administration because estate property was used to reimburse the bank. Additionally, the receiver argued that Wis. Stat. § 128.17(2) limited Stanton's claim to past due rent and payment of January 2005 rent at the rate specified in the lease. The circuit court agreed that the proceeds were property of the receivership estate and subject to the cap under Wis. Stat. § 128.17(2), entering judgment in favor the receiver for \$513,292.66 plus statutory costs and fees. Stanton appealed and the court of appeals affirmed the circuit court.

The impact of the court of appeals decision was such that those beneficiaries who entered into commercial transactions secured by a letter of credit would "be deprived of the [very] safety provided by the letter of credit that induced them to enter into the contract." (¶36). Consequently, Stanton filed a petition for review with the Wisconsin Supreme Court.

The Wisconsin Supreme Court granted the petition for review and issued a written decision addressing the following questions:

- 1) whether it violates the "independence principle" in Wis. Stat. § 405.103 and common law governing letters of credit to allow an action against Stanton, the beneficiary of a letter of credit arising out of the bank's (issuer) enforcement of its security interest against the debtor's estate;
- 2) whether Wis. Stat. § 128.17(2), which places a cap on the claims of a landlord, precludes Stanton from retaining the proceeds of the letter of credit as a beneficiary; and
- 3) whether the receiver can assert a breach of contract claim that Stanton as beneficiary drew down more proceeds than it was contractually entitled.

In a July 2010 published decision, the Wisconsin Supreme Court declines to disturb the major risk-shifting function of letters of credit. It concludes that the proceeds of the standby letters of credit are not property of Admanco, and thus, are not property of the receivership estate subject to the receiver's administration. The Court reasons: "[w]e agree that the proceeds of standby letters of credit are not property of the debtor's estate. Rather, the proceeds are property of the issuer that are paid to the beneficiary upon a proper demand. They never have been property of the debtor." (¶38).

The Court also disagrees with the lower courts' analysis of the applicability of the cap set forth in Wis. Stat. § 128.17(2) to Stanton as a landlord. This section restricts the claims of a "lessor" by limiting them to past-due rent and other specified actual damages. The lower courts cited Wis. Stat. § 128.17 as authority to preclude Stanton from retaining the proceeds of the letters of credit. However, the Supreme Court held that "the claims that are filed in a ch. 128 proceeding are claims to receive a distribution from the debtor's estate" (¶44) and emphasized the importance of recognizing that the proceeds of letters of credit are not property of the [Admanco] estate." (¶48). The Court further notes that Wis. Stat. § 128.17 is silent as to proceeds from letters of credit, which are property of issuers. It follows that since the proceeds of the letters of

SECURITY OF LETTER OF CREDIT

credit are not property of the Admanco receivership estate, Stanton's right to retain such proceeds is outside of the scope of Wis. Stat. § 128.17(2).

As for the receiver's breach of contract claim, the Supreme Court indicates that the receiver may pursue breach the contract action on behalf of Admanco because such cause of action is property of the receivership estate. The Court explains that the independence principle does not bar the receiver's ability to assert its breach of contract claim that the beneficiary impermissibly drew down on a letter of credit. Nor is such claim contingent on whether the letter of credit proceeds are property of the estate. However, the Court concludes upon review of the lease that the receiver has not set out facts sufficient to show that Stanton exceeded its rights under the lease when it accelerated payment of the rent due for the term of the lease.

In light of the Admanco decision, the letter of credit retains its identity of providing beneficiaries with the "gold standard for security" in commercial transactions governed by Wisconsin law.