

The Hidden Pitfalls Of Letters Of Credit In Lease Negotiations

By **Eric Shelby and Courtney Barr** (December 10, 2025, 5:26 PM EST)

Most leases require a tenant to provide some form of security. In a residential context, this could be a cosigner or a cash security deposit.

In commercial leasing, the lease security is usually in the form of either a cash security deposit or a standby letter of credit, or LC. Legal practitioners, landlords and tenants often have to decide whether a cash security deposit or LC is preferable.

Tenants often prefer LCs, largely for liquidity and balance sheet reasons. A cash deposit is locked up with the landlord, and does not typically earn interest or any other return for the tenant. By contrast, depending on the banking relationship, a tenant may not need to post 100% collateral for an LC and may earn interest on posted collateral.

There is typically a one-time fee for a tenant to obtain an LC and an annual fee to maintain the LC, but on balance, these fees will usually be offset by the interest earned by the tenant on the posted collateral, and the use of the additional funds if the required collateral is less than 100% of the amount of the LC.

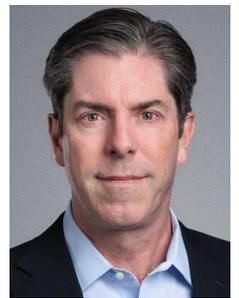
From the tenant's perspective, the LC can therefore be a cheaper and more efficient mechanism than a cash security deposit.

There is also a common misconception among landlords and practitioners that an LC is categorically better for the landlord than a cash security deposit, especially in a tenant bankruptcy scenario.

This article reconsiders that assumption. Unless the total amount of security meaningfully exceeds the Bankruptcy Code's statutory landlord damages cap, a cash security is usually superior to an LC in nearly all practical respects for landlords.

Colliers, a leading global real estate company, among others, has recently reported a surge in commercial office leasing driven by artificial intelligence and AI-infrastructure firms. Many of these firms are startups with limited financial resources, and landlords need to take care to properly securitize these leases.

This article discusses how practitioners and their clients need to be aware of the potential pitfalls of



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accepting LCs — in particular, for amounts of security that are less than the statutory bankruptcy claim cap.

The article cautions against defaulting to accepting an LC and presents a strong case for requiring cash security deposits for amounts that are less than the statutory bankruptcy claim cap amounts.

Practical Advantages of Cash Security

Cash security deposits offer many operational and risk management advantages for landlords that are often overlooked in negotiations.

Administrative Efficiency

Applying a cash security deposit to cure a tenant default requires nothing more than an internal accounting entry by the landlord.

By contrast, drawing on an LC entails presentation to the issuing bank, compliance with technical certification requirements and preparation of formal draw documentation.

As we have seen in practice, banks may reject draws on purely technical or procedural grounds — even when it is clear the landlord is permitted to draw on the LC — leaving the landlord temporarily unsecured during a dispute.

Burdensome LC Oversight

First, cash does not expire. LCs, however, are issued for specific term lengths and must be renewed, usually annually.

Even if an LC has an evergreen provision, i.e., provides that it will automatically renew each year, a bank can provide notice that it is terminating the LC, notwithstanding the evergreen provision.

If an LC terminates or expires, the landlord's security vanishes, so the expiration dates of an LC should be calendared, and a landlord should make sure not to ever let an LC expire.

Something as simple as a change in the landlord's notice address could allow an LC to expire without the landlord even realizing. The physical LC document should be kept safe, usually in a fireproof safe somewhere.

In instances where the LC does not permit fax or email, the LC must be physically presented by the landlord to the bank in order to make a draw. In addition, in order to cancel or amend an LC, the original is usually required.

These drawbacks are multiplied in a larger commercial project that might require holding and tracking dozens or hundreds of LCs.

Elimination of Bank Counterparty Risk

A cash security deposit, once in the landlord's possession, is insulated from a bank failure. An LC, by contrast, is only as reliable as the issuing institution. If the bank fails or is placed into Federal Deposit

Insurance Corp. receivership, the LC can become unenforceable.

The 2023 failures of Silicon Valley Bank and First Republic Bank illustrate this risk.

Issues Arise in a Transfer Upon Sale or a Change in the Tenant Party

When a building is sold, a cash security deposit transfers seamlessly from the prior owner to the new owner by a simple credit against the purchase price.

An LC, however, must be affirmatively transferred to the purchaser, requiring coordination with the issuing bank; execution of transfer documentation, including an indemnification of the bank by the prior landlord; and payment of fees.

There are many instances where sophisticated landlords have neglected to ensure LCs are properly transferred as part of a sale. This could be because it was a distressed sale with time pressures or a simple oversight. Without a proper transfer of the LC, the LC cannot be drawn by the new owner, and a notice that the LC is expiring will not be properly delivered.

In addition, many LCs name the original landlord in the body of the LC, necessitating an amendment to the LC as part of the transfer. Similar issues arise if the tenant changes its name or assigns the lease: The LC will need to be amended to reflect the new applicant or obligor.

Incidental Financial Benefit

Landlords are generally permitted — either by applicable law or by specific provisions in a lease — to comingle cash deposits with their own funds and retain any interest earned.

LCs: Expensive to Negotiate and Use

To protect a landlord from many of the foregoing risks, as well as from the bankruptcy risks described below, the LC provisions in sophisticated commercial leases are long and complicated, and can require expensive negotiation as the parties work to agree on acceptable language.

And for this reason, many landlords allow the LC to follow shortly after lease execution, which gives rise to a different bankruptcy issue (if the bankruptcy arises within a certain period of time following delivery of the LC) not expanded upon in this article, but should be noted.

In addition, it is usually necessary to prepare and review draw requests, LC amendments, etc.

The Bankruptcy Framework and Common Misconception

A central misconception is that an LC categorically protects a landlord from the Bankruptcy Code's landlord damages cap in Section 502(b)(6) because it is a separate bank obligation. The cap limits a landlord's permitted claim for damages upon lease termination^[1] to the greater of one year of rent, or 15% of the remaining lease term, not to exceed three years.^[2]

In practice, this means the landlord's allowed claim for future rent damages will generally be limited to an amount roughly equivalent to one year of rent (or, in longer leases, 15% of the remaining term, capped at three years), regardless of whether the security is cash or an LC.

As a practical matter, where the landlord's allowed claim is equal to or greater than the amount of the security (after application of the Section 502(b)(6) cap), the estate will generally not be entitled to compel the return of that security, and there is no issue whether the security is cash or an LC.

To say this another way, if the security — whether cash or an LC — is less than such cap, there is no issue at all.

To the extent the landlord's security (whether cash or an LC) exceeds the amount of the allowed claim (after the application of such cap), the court may require that the excess security be returned to the estate if the security is treated as the debtor's property. This is where the LC work-around debate arises.[3]

The LC Work-Around Debate Is Not Settled

The LC work-around argument is unsettled and fact-specific. A lingering debate concerns whether LCs are outside the scope of the Section 502(b)(6) cap.

Some courts have held that because the LC is a separate third-party obligation of the issuing bank, it may not be subject to the statutory limitation on a landlord's claim against the tenant's estate, including in the U.S. Court of Appeals for the Fifth Circuit's 2005 decision in *In re: Stonebridge Technologies Inc.* Other courts, however, have been skeptical of attempts to circumvent the cap in this manner, particularly where the tenant fully collateralizes the LC, reasoning that, in substance, the landlord is looking to the tenant's own funds, rather than a true third-party credit enhancement, and thus the cap should apply.[4]

Accordingly, for the portion of a deposit that is in excess of the cap, LCs may provide incremental protection, in that there is an argument that the cap doesn't apply, and that the landlord should be allowed to keep the funds in excess of the cap amount, up to the amount of the landlord's damages (as determined under state law).

The law on this point remains unsettled and fact-specific. But where a landlord is negotiating a very large security package — for example, multiple years of rent on a single-tenant headquarters lease — an LC may justify its additional complexity, because there is at least a colorable argument that a draw in excess of the Section 502(b)(6) cap remains outside the statutory limitation.[5]

Conclusion

For landlords negotiating modest security (typically one year of rent or less), cash is simpler and more efficient than an LC.

It avoids renewal and counterparty risk, reduces administrative burden, and is easier to transfer and apply.

In bankruptcy, up to the statutory cap, LCs do not outperform cash. Only where a landlord is negotiating a large security package materially in excess of the Section 502(b)(6) cap does an LC potentially justify its additional complexity, and even then the case law is mixed.

Landlords should view cash as the default for ordinary security needs and should accept LCs only after

weighing their practical drawbacks and, if used, with robust drafting to mitigate the risks discussed in this article.

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[1] 11 U.S.C. § 502(b)(6).

[2] See *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 207 (3d Cir. 2003) (explaining operation and purpose of § 502(b)(6) cap). Also, see *Collier on Bankruptcy* ¶ 502.03[7][a] (16th ed.) (describing landlord "rent cap" and its policy rationale).

[3] See *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 919–22 (2d Cir. 1944) (requiring excess security deposit above statutory limit to be returned to the estate); H.R. Rep. No. 95-595, at 353–54 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6309–10 (endorsing Oldden's approach to applying security deposits against the capped claim and returning any excess to the estate).

[4] See *EOP–Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260 (5th Cir. 2005) (holding landlord's LC draw not subject to § 502(b)(6) where landlord did not file a proof of claim); cf. *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 302–04 (B.A.P. 9th Cir. 2004); *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 209–11 (3d Cir. 2003) (treating LC proceeds or similar security as effectively part of the landlord's security deposit and applying the cap).

[5] See, e.g., Andrew N. Resnick, *Letter of Credit as a Landlord's Protection Against a Tenant Bankruptcy*, *Am. Bankr. Inst. J.* (Mar. 2006) (surveying case law on interplay between LC proceeds and § 502(b)(6)); Steven J. Lagos, *Landlords Use Letters of Credit to Bypass the Claim Cap of § 502(b)(6)*, *Am. Bankr. Inst. J.* (June 1998).