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Commercial Real Estate Leases 2019

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Commercial Real Estate Leases

Friday, February 22, 2019
9:00 A.M. – 5:00 P.M.

7.5 MCLE Credits | 7.5 Areas of Professional Practice

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Program Description

This advanced seminar covers cutting-edge topics related to commercial real estate leasing in New York State. Featured panelists include leading law firm and in-house lawyers, brokers and other professionals involved on the front lines of leasing in one of the most challenging economic climates in decades. Their insight will impart valuable perspective on where the market has moved and where the market is going for lease transactions of all sizes and types. The program is designed to impart insight on current market practices as well as explore how the challenges of the economic crisis have shifted or transformed many fundamental aspects of leasing transactions. The program will also cover the current state of insurance provisions in leases, as well as the latest trends in brokerage agreements. Finally, the program will survey options and emerging trends in enforcement of leases and alternative remedies.

Program Agenda

8:30 a.m. – 9:00 a.m.	Registration
9:00 a.m. – 9:10 a.m.	Introductory Remarks **Robert J. Shansky, Esq**. Scarola Zubatov Schaffzin, PLLC NYC
9:10 a.m. – 10:00 a.m.	Work Letters on what a Leasing Lawyer Should know about Design and Construction Agreements **Keith Reich, Esq.** Greenberg Traurig LLP NYC *(1.0 MCLE credit; 1.0 areas of professional practice)*
10:00 a.m. – 11:15 a.m.	Arbitration, Mediation and Alternative Dispute Mechanisms in Commercial Leasing **Janice MacAvoy, Esq.** Fried, Frank, Harris, Schriver & Jacobson, LLP NYC **Danielle Lesser, Esq.** Morrison Cohen, LLP NYC *(1.5 MCLE credits; 1.5 areas of professional practice)*
11:15 a.m. – 11:25 a.m.	Break
11:25 a.m. – 12:15 p.m.	Omni – Channel Leasing **Nina Kampler, Esq.** Kampler Advisory Group, LLC NYC *(1.0 MCLE credit; 1.0 areas of professional practice)*
12:15 p.m. – 1:15 p.m.	Lunch
1:15 p.m. - 2:05 p.m.	Economics of the Deal **Eric Menkes, Esq.** Duval & Stachenfeld, Esq. NYC *(1.0 MCLE credit; 1.0 areas of professional practice)*

2:05 p.m. – 2:55 p.m. Representing the Not-for-Profit in Leasing

Hope Plasha, Esq.
Patterson Belknap Webb & Tyler, LLP
NYC
(1.0 MCLE credit; 1.0 areas of professional practice)

2:55 p.m. – 3:05 p.m. Break

3:05 p.m. – 3:55 p.m. Letters of Credit and Guarantees

- Discussion of Cash vs. Letter of Credit and drawbacks regarding bankruptcy
- Lease provisions for Security, including Letters of Credit
- Guaranty Forms
- What is the Good Guy Guaranty

Bruce Leuzzi, Esq.
Law Office of Bruce Leuzzi
NYC
(1.0 MCLE credit; 1.0 areas of professional practice)

3:55 p.m. - 4:45 p.m. Basic and Non-Basic Tax Issues for Leasing Lawyers

- Tax basics of leasing
- When is a lease a sale and vice versa?
- End of synthetic leases: straight-lining of rents and new accounting rules
- Section 467 leases
- Identifying the party entitled to depreciation deductions in a ground lease of improved property
- Tax treatment of tenant improvement costs
- REIT rents problems
- Tax treatment of lease termination payments
- Use of leases in land-building splits
- Exchanging leases under new Section 1031
- Leasehold improvements exchanges
- Lease arrangements in TICs and DSTs

Bradley T. Borden, Esq.
Brooklyn Law School
NYC
(1.0 MCLE credit; 1.0 areas of professional practice)

4:45 p.m. – 5:00 p.m. Question & Answer Session

5:00 p.m. Adjournment

Accessing the Online Course Materials

Below is the link to the online course materials. These program materials are up-to-date and include supplemental materials that were not included in your course book.

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All program materials are being distributed online, allowing you more flexibility in storing this information and allowing you to copy and paste relevant portions of the materials for specific use in your practice. WiFi access is available at this location however, we cannot guarantee connection speeds. This CLE Coursebook contains materials submitted prior to the program. Supplemental materials will be added to the online course materials link.


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http://nycourts.gov/rules/jointappellate/NY-Rules-Prof-Conduct-1200.pdf

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Table of Contents

Commercial Real Estate Leasing 2019

Topic I - Alternate Dispute Resolution Procedures and Provisions in Commercial Leases

Litigation Considerations in Leasing, Arbitration v Litigation
Danielle C. Lesser, Esq., Janice Mac Avoy, Esq., and Joshua Stein, Esq. 1

The Most Important Issue in Every Ground Lease
Joshua Stein, Esq. 6

Sample Arbitration Language
Janice Mac Abvoy, Esq. & Joshua Stein, Esq. 29

Topic II - Work Letters or What Leasing Lawyers Need to Know AboutDesign and Construction Agreements

Work Letters or What Lawyers Need to Know About Design and Construction Agreements
Keith E. Reich, Esq. 35

Topic III - Economics of the Deal

Economics of the Deal
Eric G. Menkes, Esq. 41

Topic IV - Omni-Channel Leasing

Omni-Channel Leasing
Nina L. Kampler, Esq. 43

Topic V - Representing the Not-For-Profit Entity in Leasing

Representing Not-for-Profit Tenants
Andrew L. Herz, Esq. & Hope K. Plasha, Esq...... 55

Leasing Issues for Tax Exempt Entities
Sunjata Yalamanchili, Esq. 58

Implications of Sale Leaseback Transactions
Sunjata Yalamanchili, Esq. 63

Table of Contents

Commercial Real Estate Leasing 2019

Topic VI – Letters of Credit and Guarantee

Letters of Credit and Guarantees and Case Law
Michael Reyan 67

Letter of Credit and Guarantees
Bruce J. Leuzzi, Esq. 95

Basic and Non-Basic Tax Tips for Leasing Lawyers
Bradley T. Borden, Esq. 239

Topic I

Alternate Dispute Resolution Procedures and Provisions in Commercial Leases

By Janice Mac Avoy, Esq., Danielle C. Lesser, Esq., and Joshua Stein, Esq.

Litigation Considerations in Leasing: Arbitration vs. Litigation

Janice Mac Avoy
Fried, Frank, Harris, Shriver & Jacobson LLP

Danielle C. Lesser
Morrison Cohen LLP

I. ARBITRATION VS. LITIGATION

A. Advantages and disadvantages of arbitration: Arbitration can be quicker than a plenary action in Supreme Court – arbitration has limited, more streamlined discovery (or no discovery if lease so provides), but may take longer than a summary proceeding in Civil Court. Arbitrators can be selected based on specialized knowledge or can be pre-selected in the lease itself.

1. Carefully consider the qualifications of the arbitrator and whether there will be qualified arbitrators available.

2. Consider whether some or all disputes will be arbitrated:

   (a) Just FMV resets?

   (b) All disputes?

B. Will you be better served by imposing the higher costs of litigation on the other side?

C. Consider the tendency of arbitrators to "split the baby." This can be minimized by using a baseball provision -- where the arbitrator selects only one party's determination, whichever is closer to correct.

D. Certain types of disputes are better suited to submission to arbitration before arbitrators with specialized knowledge, such as fair market rent re-sets, where arbitrators are typically appraisers with specialized knowledge of market value, or construction disputes that arise during major tenant improvement construction work, which must be decided quickly and benefit from an arbitrator with construction-related expertise.

1. For matters that will only arise in the initial stages of the lease, such as disputes over construction or tenant build-outs, considerthat pre-selecting arbitrators can quickly rule.

2. Consult with a litigator before setting pre-determined time periods for an expedited arbitration. While certain disputes must be resolved quickly, you want to provide time for your litigators to be able to

adequately prepare their case.

E. Arbitration clauses typically provide for either a single arbitrator or a panel of three arbitrators. If a panel of three is chosen, the lease should specify that:

1. Party-appointed arbitrators are non-neutral, and each party may have *ex parte* communications with their party-appointed arbitrator.

2. The role of party-appointed arbitrators – whether they can cross-examine witnesses, provide testimony, what is their role in deliberations?

3. Baseball arbitration (arbitrator may select only landlord or tenant's determination, may not make his/her own determination) vs. majority decision vs. unanimous decision: baseball arbitration keeps the parties honest and will require them to make a reasonable submission to the arbitrators, making settlement more likely. Requiring a unanimous decision creates the possibility of deadlock, whereas a simple majority decision creates the possibility that the arbitrators will "split the baby" – a common complaint about arbitration.

4. Consider the cost and effectiveness of a panel of three versus the unpredictability of a single arbitrator.

F. The arbitration clause may provide expressly whether a court or the arbitrator should decide threshold questions of arbitrability in the first instance. In the absence of such an express provisions, the courts will presume that the parties intended for the court to decide the threshold question of whether or not the dispute is arbitrable. *First Options of Chi v. Kaplan*, 514 U.S. 938, 943 (1995). However, if the arbitration clause provides that AAA rules apply, the arbitrator will decide the question of arbitrability in the first instance, pursuant to AAA rules. *See* AAA Commercial Arbitration Rules, R-7(a) (effective Oct. 1, 2013) ("The arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim."). Thus, by incorporating the AAA Arbitration Rules, the Parties agreed to delegate any questions of arbitrability to the arbitral tribunal. *See Life Receivables Tr. v. Goshawk Syndicate 102 at Lloyd's*, 66 A.D.3d 495, 495-96 (1st Dep't 2009) ("Although the question of arbitrability is generally an issue for judicial determination, when the

parties' agreement specifically incorporates by reference the AAA rules, which provide that '[t]he tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement,' and employs language referring 'all disputes' to arbitration, courts will 'leave the question of arbitrability to the arbitrators….'") (citation omitted), *aff'd*, 14 N.Y.3d 850 (2010).

G. If there is a challenge to the validity of the arbitration clause itself, however, that challenge must be decided by a court, not the arbitrator. *Matter of Teleserve Sys., Inc. (MCI Telecommuns. Corp.)*, 230 A.D.2d 585, 592-93, 659, N.Y.S.2d 659, 664 (4th Dep't 1997). But "courts look only to whether the arbitration clause itself was induced by fraud or duress; the question of whether the overall agreement is invalid is for the arbitrators" to decide. *Zurich Ins. Co. v. R. Elec., Inc.*, 5 A.D.3d 338, 339, 773 N.Y.S.2d 560, 560 (1st Dep't 2004). If a court concludes, however, that "the alleged fraud was part of a grand scheme that permeated the entire contract, including the arbitration provision, the arbitration provision should fall with the rest of the contract." *Weinrott v. Carp*, 32 N.Y.2d 190, 197, 344 N.Y.S.2d 848, 855(1973).

H. Under New York law, an arbitration award is conclusive and binding on the parties absent fraud, illegality or undisclosed bias. The parties may not challenge the arbitration award simply on the basis that the arbitrator wrongly decided the law or the facts. See *DigiTelCom v. Telez Sverige*, 2012 WL 3065345 (S.D.N.Y. July 25, 2012) (sanctioning law firm for frivolous challenge to arbitration award: "Plaintiff's challenge to the Award amounts to little more than an [improper] assault on the Tribunal's fact finding and contratual interpretation rather than on its actual authority"). *But see LJL 33rd Street Associates, LLC v. Pit Cairn Properties, Inc.*, 11 Civ. 6399 (JSR) (S.D.N.Y. Feb. 15, 2012) (arbitrator's valuation overturned for improperly excluding evidence relating to the fair market value of the property). In addition, courts have set aside arbitration awards when the arbitrator exceeded his or her authority. *N.Y. by Off. of Mun. Labor Rel. v. Davis*, 146 A.D.2d 480, 482-83 (1st Dep't 1989) (finding that the arbitrator violated a provision in the agreement that he "shall not add to, subtract from or modify any contract" when he cited nonexistent provisions and relied on matters outside of the agreement).

I. Consider that arbitration is private and confidential vs. a case filed in court, where all papers filed are publicly available.

THE MOST IMPORTANT ISSUE IN EVERY GROUND LEASE

RENT RESETS AND REDETERMINATIONS, FAIR MARKET AND OTHERWISE

Joshua Stein[1]

When a Landlord and a developer (Tenant) negotiate a long-term ground lease of a development site, one issue overshadows almost all others: how should ground rent adjust over time to protect Landlord from inflation? And how can Landlord participate in future increases in value of the property, which may or may not correlate with inflation? At the same time, how can Tenant assure that its leasehold position will also maintain its value? To do that, Tenant must know that it will never face the risk of paying too much rent.

1.1. *Typical Approach.* Landlords and Tenants typically resolve these concerns by agreeing that every two or three decades, they will reappraise the development site that Landlord originally delivered. In my experience, the annual ground rent will then adjust to equal 6% or 7%[2] of the then current fair market, i.e., whatever someone would pay to purchase the site

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[1] Joshua Stein practices commercial real estate law at Joshua Stein PLLC in New York City. For information on the author, visit www.joshuastein.com. The author appreciates helpful comments from Stevens A. Carey of Pircher, Nichols & Meeks, LA; Carl Gaines, former editor of the Mortgage Observer, NY and now with Capital One Bank; Janet M. Johnson of Schiff Hardin LLP, Chicago; Alfredo R. Lagamon, Jr., of Ernst & Young LLP; Janice Mac Avoy of Fried, Frank, Harris, Shriver & Jacobson LLP; Donald H. Oppenheim of Berkeley, CA; Benjamin Polen of Polestar Realty LLC, NY; Elizabeth T. Power and later Karen Lively, the author's managing editors; Robert M. Safron of Patterson Belknap Webb & Tyler LLP, NY; Lawrence Uchill of Uchill Law, PLLC, Newton, MA; and Michael B. Vincenti of Wyatt, Tarrant & Combs, LLP, Louisville, KY. Alexa Klein, Deborah Goldman, James Patalano, and Lauren Silk, attorneys at Joshua Stein PLLC, also made substantial contributions, all very much appreciated. A prominent but anonymous New York City appraiser commented extensively on this article. Blame only the author for any errors. Earlier versions of this article appeared in the ACREL Newsletter; Mortgage Observer; New York State Bar Association Real Property Law Journal; Practical Real Estate Lawyer; ACREL Papers (March 2014 Kauai); and elsewhere. Readers are encouraged to comment on and respond to this article by sending email to joshua@joshuastein.com.

[2] In the many Leases I see, old and new, I have been struck by how consistently the rent adjustment factor falls within that range, with only very few outlying cases. But my view

Footnote Continued on Next Page.

vacant. Until that happens, rent may go up a bit every year or few years[3]—or not, especially in older ground leases. Over time, ground rent often fails to keep up with inflation, at least until the next land value reset. In most cases, the rent never drops.

The reference to 6% or 7% in rent adjustment formulas has, again based solely on my own experience, mostly remained very stable for quite a while, even through the very low interest rates of the last few years. At the time of writing (early 2018), however, I have seen a few new transactions with a constant a bit below 6%. In one case, for example, Tenant proposed 4.5% and the parties settled on 5.25%. If interest rates rise significantly, 6% to 7% will probably again become standard.

Although Leases very often follow this approach, prospective Tenants sometimes worry about unpleasant surprises. Those surprises occur because, in a period of low interest rates, real estate investors are willing to accept lower rates of return. Hence capitalization rates in the overall real estate market eventually decline. This drives values, including land values, higher. If,

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of "market standard" reflects nothing more than the accumulated deals that happen to have crossed my desk—the piece of the elephant I happen to have touched. Others may have different experiences. For them, "market standard" may mean something else entirely. Ultimately, the "market" terms for any particular deal depend entirely on what those particular parties happen to negotiate taking into account the business context of their own transaction. In one transaction handled by the author involving a particularly unusual and desirable location, the parties negotiated a 10% constant. An older lease, predating the author's involvement, contemplated a 12% constant and threatened complete destruction of the leasehold.

[3] These annual increases, typically small, add up significantly over time. They usually take the form of a CPI increase, annually or every few years, subject to a low cap. That cap may apply to either: (a) each increase or (b) all increases, considered as a whole, since the start date of the Lease. Which party will benefit more from which type of cap will not always be obvious. The CPI adjustment will also often have a floor: either the rent can never go down or it will always go up by at least, e.g., 2%, even if CPI goes down. Over time, those annual floors can make the rent build up in a way that makes no sense—especially if the economy experiences deflation followed by inflation or the reverse—but caps and floors are definitely part of the territory in these annual adjustments. Even the routine calculation of those caps and floors can sometimes leave room for misunderstandings and misinterpretations. CPI adjustment formulas, especially if complicated, can sometimes produce surprises. Anyone writing such a formula should make it as simple as possible, but to paraphrase Einstein, no simpler. Someone else should test it. One must also consider exactly which inflation-based index to use—one version of the CPI or something else—and for what geographical area. The choice of index may matter. That issue lies beyond the scope of this article.

at the time of a rent adjustment, the capitalization value baked into land value[4] falls significantly below 6%, Tenant may find that the use of a 6% constant results in a completely uneconomic leasehold.

If Tenant's existing improvements cannot compete effectively against hypothetical new buildings, or if Tenant can only use the existing improvements for some use other than the "highest and best use" (if the land valuation reflects the "highest and best use" or something like it), this will compound Tenant's problems. It gets even worse for Tenant if Tenant's existing building has become landmarked, or if the existing use is no longer the "highest and best use" but it would be prohibitively expensive to alter the existing improvements.

These issues have worsened for Tenants in recent years in New York City, where former business/office districts, such as Park Avenue South and the Financial District, have seen a huge rise in residential development. Tenants may find themselves stuck with an office building whose highest and best use is residential condominiums, but Tenant has neither the ability (because condominiums may not be built on leased land) or the financial wherewithal to convert to residential. Yet the Lease reset formula may value the land based on the possibility of residential conversion.

1.2. *Lender's Concerns.* Leasehold lenders, generally even more conservative than developers and investors, will likewise fear that a massive increase in ground rent at some distant date will diminish or destroy the security for their loans. Though "cowboy" developers may sometimes take risks, lenders rarely have the same mindset. They never forget that the obligation to pay ground rent is almost always structurally senior to any leasehold lender's collateral.[5]

In response to these concerns, a lender or prospective Tenant will sometimes suggest a cap on ground rent adjustments. Typically, though, Landlord will regard any such proposal as a

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[4] Assuming a reasonable volume of comparable land sales, the appraisers will typically prefer to rely on comparable sales rather than capitalization of projected income at current capitalization rates. But those land sales also reflect a capitalization of projected income, as estimated by buyers/developers, using current capitalization rates, so ultimately the analysis gets to the same place.

[5] This assumes, of course, that Landlord will not join in the leasehold mortgage, sometimes referred to colloquially and incorrectly (and, in the eyes of some courts, almost humorously) as "subordinating the fee." In today's market, that assumption is almost always correct. This article accepts it as part of the territory. In the rare case where Landlord joins in Tenant's leasehold mortgage, Landlord should reasonably demand some extra compensation for the extra risk assumed. Occasionally, a Lease will "subordinate" part of the ground rent to payment of debt service. If the lender ever foreclosed, then the "subordinated" component of the ground rent would go away. This is quite uncommon, though.

non-starter, because it necessarily undercuts the inflation protection that Landlord sought through the future ground rent adjustments.

Applying a fixed percentage (e.g., 6%) to future land values will create problems for both Tenant and its lender—and wonderful results for Landlord—if, at the moment of the rent reset, valuations in the larger real estate market use capitalization rates significantly below the fixed percentage specified in the Lease. At any such time, real estate values will reflect a capitalization of future income at, say, 4%, but the Lease will require payment of ground rent at, say, 6% of that capitalized amount, which may put Tenant in an untenable position and undercut or destroy the value of the leasehold lender's collateral.

Any Landlord will point out that any concern about Tenant's position should be tempered by thinking about Landlord's position under many ground leases. These leases often start out with a free rent period, followed by at least a few decades governed by a fixed rent schedule that, in many cases, does not rise as fast as real estate values. So naturally when the rent adjusts to market, Tenant's "good deal" will end and this will cause shock. But the shock is simply a correction for a rent schedule that protected Tenant from the market, often for an extended time.

1.3. *Linkage To Interest Rates?* Some Leases try to mitigate the risk of shocking rent increases by replacing a fixed adjustment percentage with a percentage tied to interest rates at the time of the rent reset. The parties might choose a long-term rate like 20-year Treasury securities, or, more unusually, they might use a shorter-term one like the prime rate. In either case, they would look at the average level of that rate over some period and then add a spread.

Although some commentators may have seen a trend toward this type of formula, I have not. Like many of the comments in this article about "typical" practice, though, my failure to note the trend might only reflect the particular universe of Lease transactions that I have been involved with or seen recently. Or it could reflect a market perception that in the long run—i.e., multiple business cycles—6% or 7% has worked reasonably well, and there's no reason to think it will stop working reasonably well any time soon.

Of course, if a "typical" rent reset occurs in a real estate depression, or at any time when valuations use very high capitalization rates, Tenant may get lucky.

1.4. *Fair Market Rental Value?* Very occasionally, the revaluation might direct an appraiser to determine the new rent based generally on market conditions for newly negotiated Leases at the time of the rent reset. In other words, the rent would adjust to equal "fair market rental value" at the time of adjustment, with no formula to derive the rent adjustment from land value or anything else. The Lease drafters must still define with absolute clarity how fair market rental value is to be determined. They also must define any assumptions the appraiser should consider in that process. Does the appraiser consider vacant land? The existing improvements? If improvements are taken into account, any such adjustment creates a substantial risk that, after adjustment, the leasehold will have no value to Tenant.

Assuming the "fair market rental value" determination refers to land value only, it probably would require the appraiser to reverse-engineer a typical land value rent reset. First, they would consider current Lease negotiations, identifying the land value constant percentage

that market participants typically agree on, at the time in question, in those negotiations.[6] As of mid 2018, that constant would probably be 6% or perhaps slightly below that. Second, the appraiser would turn to determination of land value in the usual fashion. So a reference to "fair market rental value" would require the appraiser to make two market-based determinations rather than one. That creates more work and more risk of mistakes, but might protect Tenants from the risk of, e.g., a 6% land value constant at a time of very low capitalization rates in commercial real estate. While in theory this approach may seem fair, lenders will hate it because of its uncertainty. Hence it may be unfinanceable.

1.5. *Valuation On A Range Of Dates.* Lease negotiators sometimes suggest that instead of valuing the site on a specific date, the valuation should look to a range of dates, using the average value over, say, a three- or five-year period. If that period ends on the intended rent reset date, then the valuation process will automatically undercompensate Landlord a bit if real estate values are rising over that period, which they usually (but not always) do over any extended period. The midpoint of the valuation period could instead be the intended rent reset date, with suitable adjustments once the final average value has been determined.

That approach may make some sense. Suppose a rent reset used a single fixed valuation date of October 1, 2008, two weeks after the Lehman Brothers bankruptcy filing. Given the state of the financial and commercial real estate worlds on that date, Landlord would probably feel victimized by a very low valuation.[7] Going forward, that particular Landlord might favor using an average of the values on multiple dates over multiple years.

If the parties agreed to a valuation on a range of dates, would that mean, for example, they would need to order five complete appraisals? As a general proposition, appraisers like to do a complete job as of a particular date. They say an appraisal speaks only as of that date, taking into account all relevant circumstances as of that date. Unless the parties varied from that

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6 Two possible land value constants might apply. First, the appraisers might look at newly signed Leases and examine the ratio, expressed as a percentage, between the initial rent, with suitable adjustment for any rent abatement, and the value of the land at that time. Second, the appraisers might look at how those newly signed Leases set up future land value rent resets—what percentage constants do they use? Those two possible land value constants will not always match up perfectly, even though one might think they logically should. If the Lease doesn't contain clear instructions, the appraisers will need to make a judgment call, thus introducing further uncertainty and room for dispute. Whichever party dislikes the outcome will claim the appraisers got it wrong.

7 In all likelihood, however, this Landlord's victimization was mitigated by the fact that the Lease probably said ground rent could never go down, even if land values dropped. So it could have been worse for Landlord. And Tenant may have felt victimized by having to pay ground rent higher than what it should have been based on pure land value at the time of the reset.

principle by contract, they would in fact probably need to obtain five appraisals, significantly driving up the cost, time, and potential for disputes.

With suitable advice from an appraiser, though, they might be able to negotiate a specific "primary" appraisal date, with only certain adjustments to be made based on specified market conditions (e.g., capitalization rates, vacancy rates, and general inflation) on other dates before and after that primary appraisal date. Any such appraisal structure would break new ground, as well as new ground for disputes. It could also create problems for appraisers, who always want to value land as of a specified date.

Landlords and Tenants generally prefer, however, to avoid the time, expense, drama, and logistical difficulties of dealing with multiple appraisal dates. They tend to feel that way even though an average of multiple appraisals might make the calculation less arbitrary. The use of a single bright-line date introduces a greater element of luck for both parties, but historically both parties have seemed generally willing to take their chances. And Landlord derives some comfort from the fact that any Lease usually says rent can never go down.

The need to periodically revalue the site for ground rent adjustment invites litigation or arbitration. For obvious reasons, Landlord and Tenant will have dramatically different ideas of the value of the land, or of how an appraiser should proceed, particularly as markets and other circumstances change. The exact wording of the Lease, and how it addresses those possible changes, becomes crucially important in determining what exactly the appraiser should appraise and how to go about it.

For instance: should the appraiser appraise raw land, or should the appraisal include improvements? Should the appraisal include the improvements that existed on the site when the parties signed their Lease, or whatever improvements exist at the time of revaluation? This is a common disagreement. The Lease should entirely pre-empt that disagreement, by telling the appraiser whether or not (and how) to consider the improvements on the site. In general, the appraiser should try to replicate whatever existed when the parties signed the Lease, usually vacant land.[8] To avoid confusion, the Lease should say that as clearly as possible. And Tenant should remember that if Tenant plans to build improvements, any land value calculation should typically disregard those improvements.[9]

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[8] What if that vacant land had serious environmental contamination at inception of the Lease? Should those circumstances count as deductions when valuing the land at some later date for a ground rent reset? After all, Tenant will spend money to clean up the mess, so why should future land valuations give Landlord the benefit of that cleanup, any more than Landlord should get the benefit, for valuation purposes, of Tenant's beautiful new office tower?

[9] Although this statement is usually true, the author has seen ground rent reset disputes where Tenant can reasonably argue that land and building, together, are worth less than vacant land. This can occur, for example, if the building is obsolete and far below current

Footnote Continued on Next Page.

Perhaps the appraiser should consider the leased land in the context of surrounding land. For example, suppose the leased land consists of a small midblock site that a future developer might conceivably at some point redevelop as part of a larger assemblage. Does the potential of such an assemblage justify a higher appraisal? What if, at the date of determination, such an assemblage and redevelopment has actually occurred? These are great questions but might best be left to the appraiser. On the other hand, Landlord or Tenant may feel more comfortable if the Lease handles them expressly. Silence leaves the possibility of a fight.

1.6. *Ground Leases Of More Than Just Ground.* If improvements existed at Lease inception, and Landlord initially demised those improvements to Tenant along with the underlying "ground," the market will often still call the transaction a "ground lease," even though it covers existing improvements and not just ground. The characterization as a "ground lease" would depend largely on whether Tenant's rights and obligations looked more like ownership (an investment transaction, with value in the marketplace, and typically regarded as a "ground lease") or more like mere rights of occupancy not readily salable or financeable in the market (a "space lease").[10]

If a Lease demises improvements that exist at the time of lease inception, the rent reset should usually consider only the improvements as they existed at that time. If, for example, Landlord delivered an old warehouse with "solid bones" ready for redevelopment, then the rent reset clause should require the appraiser to figure out what that particular building would be worth at the time of the rent reset, if it were still in the same condition as when Landlord delivered it. This requires the parties to somehow take a snapshot of the existing building at Lease inception. This can entail a literal snapshot—a collection of photographs—as well as a conceptual description, written with a relatively broad brush. Later, the appraiser needs to

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market standards, requires tremendous capital expenditures, or is stuck with an outdated use not readily changed.

[10] Can a ground lease demise part of a building? Must a ground lease demise at least some ground as part of the transaction? To define a transaction as a ground lease, the author would look to the character of the leasehold estate created—the terms of the Lease—not placing great weight on whether the Lease demises any ground, raw land, or a building. Others, including Black's Law Dictionary and some prominent New York City commercial real estate lawyers, disagree, arguing that a "ground lease" needs to demise some ground, or it isn't a "ground lease." In the author's mind, if it is an investment/development transaction and Tenant has substantial control and flexibility, then it's a ground lease. If it is an occupancy transaction or Tenant's hands are tied regarding the space, then it is a space lease. If it starts out demising ground, it will soon enough cover a building as well, and it's still a ground lease. For more on the distinction between a "ground lease" and some other form of lease, please see GROUND LEASE VS. BUILDING LEASE (WHAT'S A GROUND LEASE ANYWAY?), in the Encyclopedia of Ground Lease chapter in Joshua Stein's upcoming book on ground leases.

understand what hypothetical physical condition of the building is supposed to be appraised, so the parties need to document it in some reasonable way.[11]

Of course, if the existing improvements at Lease inception have no value and Tenant will need to demolish them. Tenant might go a step further, arguing that any future valuation of "raw land" overstates the value of what Landlord delivered, because Landlord delivered land with improvements that required demolition. So, at the time of the reset, Tenant would argue the appraisers should try to value raw land (as if vacant) and then subtract the cost of demolishing the obsolete improvements from that value. If Landlord has any negotiating leverage at all, Landlord will typically be able to reject that concept.

A sloppy rent reset clause might, however, unintentionally require the appraiser to take into account any development, upgrading, or expansion that Tenant accomplished. This reasonable-sounding minor detail would effectively force Tenant to pay rent in exchange for value that Tenant rather than Landlord created or provided. Forcing Tenant to pay twice for whatever (re)development Tenant accomplished—once when doing the work, a second time by paying adjusted rent based on the completed work—hardly seems "fair." Fair or not, Lease language should resolve that question and not leave it to courts, appraisers, or arbitrators.

Occasionally, though, at the time of any rent reset the improvements are obsolete and a net minus to value. In those cases, Tenant will argue that the appraisal should consider the improvements as part of the value of the site, because land and bad improvements together are worth less than just raw land. As a variation, Tenant may try to argue that the land should be valued to take into account only the potential to build whatever improvements actually exist. None of these arguments should ever actually need to occur, though, because the lease should prevent them.

1.7. *Future Changes In The Site.* Any Lease negotiator also should consider possible future disconnects between the development potential of raw land (assumed to be unimproved, and available for development to its highest and best use consistent with then-current law) and the actual physical development that exists on the site at the time of any rent reset.

For example, changes in zoning or other law could change the value of the site, if it were priced as hypothetical raw land. If at some future date the municipality decides to double the permitted bulk on the same land, then the same land could in the most extreme case double in value overnight, assuming the site can feasibly exploit all the new bulk.[12]

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[11] As a simpler alternative, perhaps future appraisals could consider hypothetical vacant land, and then add some agreed percentage to reflect the value of the improvements that existed at Lease inception.

[12] In New York City, the right word for "bulk" is "floor area," as defined in the Zoning Resolution. By referring to floor area, one avoids potential disputes over the meaning of developable space in a building. In contrast, "gross building area" is something else, potentially larger, and "rentable area" is a highly elastic and potentially fictional concept.

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Similarly, suppose zoning allows only construction of, say, a hotel at Lease inception, and so Tenant proceeds to build a hotel. Then suppose the municipality in its wisdom later decides to allow a wide range of additional uses, one of which is more valuable (at the time of rent reset) than construction of a hotel.

For the rent reset, though, the parties need to consider one not-so-minor detail: if the transaction played out as the parties originally anticipated, then by the time of the rent reset Tenant will have already built improvements on the land. At the time of the rent reset, those improvements will probably not be obsolete—i.e., ready for demolition or major redevelopment.

If zoning at the time of the rent reset would allow much more (or different and more valuable) development than the building already in place at that time, then that upzoning does not help Tenant much. If Tenant must pay rent for newly created development potential (or the ability to change to a more valuable use) that Tenant cannot really exploit, or if Tenant's existing structure can't generate net operating income equivalent to the hypothetical new construction that the improved zoning would allow, then Tenant's leasehold may no longer make economic sense. The parties can address this issue in a few ways.

- *Actual Exploitation at Time of Reset.* If at the time of the rent reset, Tenant has actually exploited the site's increased development potential, then it's reasonable to take that greater development potential into account for the land valuation.

- *Additional Reset Date*. If at any date in between land value rent resets, Tenant actually does exploit the increased development potential, then Landlord can require an additional land value rent reset, perhaps after some reasonable waiting period.

- *Long Waiting Period*. Even if Tenant has not yet exploited the increased development potential but a certain period has passed since the change in zoning (e.g., 25 years), then Landlord can require any later appraisal to consider the improved zoning, whether or not Tenant has figured out a way to exploit it. In effect, the Lease would force Tenant, over time, to exploit any enhanced development potential. It is a first or second cousin to the classic "single-tax" plan advocated by Henry George, John Locke, and Baruch Spinoza, by which the government would tax vacant land based on its highest and best use to encourage the landowner to develop that use for the benefit of society (or, in this case, to encourage Tenant to develop the land for Landlord's benefit).

Just because the Zoning Resolution allows a certain amount of bulk on a site, that doesn't mean a developer could actually build a structure using all that bulk. Height limits, sky exposure planes, setbacks, and other constraints might limit the use of bulk otherwise available. Wherever the text refers to Tenant's exploitation of available bulk, that refers to bulk that Tenant could in fact use given all constraints that apply to the site.

Any of these possibilities must recognize that a complete redevelopment of a structure is not the real estate equivalent of changing clothes. It is probably unfair to expect Tenant to squeeze every dime out of a property for the passive Landlord who bears far less risk in redevelopment—except Tenant bankruptcy—than Tenant faces, and who, after all, has not sold its property and will receive the land back at the end of the Lease term. The time, risk, cost, and ingenuity entailed in redevelopment should perhaps be valued and deducted from any of the above reset formulas.

Conversely, if zoning changes have reduced the permitted development on the site, but Tenant's improvements are now overbuilt and can remain as a legal nonconforming use, then Landlord would argue that the revaluation process should ignore the downzoning. On the other hand, if the overbuilt improvements had burnt down and could not be restored, Tenant would argue for rent relief. Landlord's response would depend in part on whether, after the fire, Landlord received enough insurance proceeds to justify a rent reduction.[13]

Another question along those same lines: should newly discovered environmental issues affect land value? The answer will depend in part on which party bears the risk of unexpected environmental conditions, taking into account the terms of the Lease. And what if some government decides to issue a landmark designation for the existing improvements?

1.8. *Appraisal Subject to Terms of Lease.* Landlord and Tenant might also find themselves fighting over whether any appraisal of the land should "consider the terms of the Lease," a concept that appears in many older ground rent adjustment clauses and a few newer ones. In New York, if the Lease is silent, the fair market value will be deemed to be subject to the existence and terms of the Lease.[14]

The whole concept seems circular. That's because the value of Landlord's land, if considered subject to the terms of the Lease, will depend largely on the amount of the ground rent, assuming Tenant is reasonably likely to actually pay that ground rent. Thus, it may not make sense to consider the ground rent in measuring the value of the land for purposes of determining the ground rent.

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13 In any discussion of Leases, many roads lead to issues of condemnation and casualty. The problem of an "overbuilt" building arises regularly. Any building could, at some future point, become "overbuilt" if the site is later downzoned. So the issue can arise anywhere, any time, in any Lease, not just for Leases that demise buildings that one already knows are "overbuilt." Many Leases don't adequately address that possibility.

14 936 Second Avenue L.P. v. Second Corporate Development Co., Inc., 10 N.Y.3d 628; 629-30 (2008) ("[T]he issue is whether the net lease itself must be considered by appraisers in valuing the demised premises for purposes of establishing the net rent for a renewal term of the lease. Because the net lease does not exclude its consideration, we conclude that it must be taken into account in valuing the property.")

One can eliminate any possible circularity by deciding that the parties probably did not intend to create an indeterminable formula. Instead, the parties must have meant that any valuation of the land should take into account any Lease terms that limit permitted uses or other rights of Tenant. That is probably the best way to interpret any reference to appraising the land, considered subject to the terms of the Lease.

For example, land will have a higher value if it can be used for "any permitted use." If, on the other hand, the Lease says Tenant can use the site only to construct a "car wash with ancillary coffee shop," regardless of what the law might then allow, then that limited range of uses—if applied to the land value as part of the appraisal process—will drive down the value of the land. In this case, "considering the terms of the Lease" means accounting for how much those terms decrease the value of the land, if treated as binding restrictions on use of the land. It makes sense: if the Lease allows Tenant to construct only a car wash with an ancillary coffee shop, then Tenant should not pay rent for the right to build a 50-story office building, even if zoning law might allow it.

But "considering the terms of the Lease" could also mean something more. It could also mean the appraiser should consider anything else in the Lease, except ground rent, that—if hypothetically treated as a burden on Landlord—increases or decreases the value of Landlord's position. For example, if the Lease gives Tenant a below-market purchase option, this will lower the value of Landlord's position. And what if the Lease requires Landlord to deliver to Tenant some nonstandard but expensive service? Is that a term of the Lease that the appraisers should consider in valuing the land "considering the terms of the Lease"? What if the Lease limits Tenant's financing to 50% of the cost of Tenant's construction?

If the Lease has only a decade or two left in its term, then perhaps an appraisal "considering the terms of the Lease" should consider the fact that, as an economic matter, Tenant doesn't have enough "useful life" left to justify a major construction or redevelopment project. Should the appraiser consider that as a negative in measuring the value of the land "subject to the terms of the Lease"? Isn't the short remaining life of the Lease a term that ought to be considered? But does it really affect the value of the land in any way?

These are all fascinating questions. Tenant could raise any of them as an argument to lower the value of the land for the rent reset. Litigators and courts and expert witnesses could have a lot of fun and deep thought resolving all these issues. Lease writers should deny them that pleasure. Again, the words of the Lease rent revaluation formula should leave no uncertainty. Of course one still needs to count on the appraisers to read those words and interpret them correctly.

As another variation on this theme, in New York, a developer generally cannot construct for-sale condominium apartments on a Lease. It's just prohibited, except in a few favored locations. So if the appraisers must appraise the land "considered subject to the terms of the

Lease," does this mean they should disregard any incremental value that might result from the potential ability to develop condominium apartments on the site?[15]

Over an extended time, differences of opinion on these and similar issues translate directly to dollars—lots of them. Any careful Lease writer should prevent the issue by avoiding any suggestion that the appraisers should "consider the terms of the Lease." Instead, the appraisal clause in the Lease should state exactly what circumstances the appraiser should consider, and what assumptions the appraiser should make. If the appraiser should assume Tenant can operate only the narrow scope of uses the Lease allows, that's what the appraisal clause should say. If other particular provisions of the Lease should increase or decrease value, identify them. And if the appraiser should disregard the terms of the Lease entirely, that's what the appraisal clause should say.

Anyone writing a land value rent reset clause in a Lease should consider asking appraisers whether they can understand and apply the language as written. After all, everyone hopes (one hopes) that appraisers rather than lawyers or courts will be the parties charged with interpreting and applying the words in the Lease.

Even if the Lease handles the panoply of appraisal issues correctly, the "standard formula" described above—6% or 7% of land value—will never precisely correlate with what the adjusted rent "should be" according to some "fair" view of the world. It is a crapshoot. But Landlords and Tenants often still take their chances, recognizing that there may be surprises while comforting themselves by knowing that this is the way everyone does it (or at least many people do it or have historically done it), and that lenders have underwritten and financed similar leaseholds for decades.

1.9. *Is There A Better Way?* Landlords and Tenants do sometimes try to find a logically superior and perhaps less risky way to handle ground rent adjustments. They often start by suggesting that the ground rent should reflect Tenant's revenues, at least in part. Landlord could receive some percentage of "gross revenues," perhaps after modest deductions, and perhaps with a floor.[16] That percentage might reflect the expected ratio between the value of the land and the value of Tenant's completed development project.

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[15] Conversely, if the Lease says nothing about any of this, should the appraiser value the hypothetical vacant land as if it could be developed for condominiums, even though the developer (Tenant) can't legally undertake that sort of development? In New York at least, the *936 Second Avenue* case cited above probably means: (a) the appraiser must consider the existence of the Lease; (b) the existence of a Lease precludes condominium development under New York law; and therefore (c) the appraiser should not consider the possibility of condominium development.

[16] In a hotel or other asset with multiple revenue streams, different percentages might apply to different revenue streams, perhaps changing with market conditions. Although that sounds brilliant—and a good way to protect Tenant from uneconomic ground rent

Footnote Continued on Next Page.

It sounds reasonable. But what if Tenant does not try very hard to rent space in the completed development project? Or occupies the space itself to conduct business? Or subleases the space to a chain store at below-market rents while simultaneously entering into an above-market lease with the same chain store in another state? What if Tenant does a lousy job with subleasing, or fails to invest the capital necessary to achieve the highest rents? And what should the Lease allow Tenant to deduct? Leasing costs? Capital expenditures necessary to attract space tenants? Unexpected energy costs or uninsured casualty repairs? If Tenant borrowed money to improve the property, should Tenant have the right to deduct debt service? Interest? At what rate? How does Landlord know Tenant is not lying or artificially reducing its revenues? Before long, the exercise reinvents the Internal Revenue Code.

If Landlord and Tenant do decide to go down that road, then they (particularly Landlord) should take a few measures to prevent disputes. Keep it dumb and simple, avoiding exclusions, complex characterizations, and fine lines whenever possible. They all provide fertile ground for misunderstandings, mischaracterizations, strategizing, gaming the system, and disputes. Try to give Landlord a low percentage of a broadly defined variable without many deductions. Gross revenue with no deductions at all has a lot of appeal to it. Paint with a broad brush. Think about every possible circumstance that might occur and how it might play out given the Lease language and definitions. Consider the issues that have arisen with shared appreciation or cash flow mortgages. Finally, ask an appraiser and a lender how they would interpret, and react to, whatever brilliant contingent rent clause the parties think they want to perpetrate.

Any rent formula that awards Landlord a share of Tenant's financial results will work best (if it works at all) as a continuing participation with annual calculations and payments. Otherwise, it gives Tenant an opportunity to game the system at the time of the rent reset. Tenant could, at that time, claim poverty. Or, in the years just before the reset, Tenant might undermanage the building, e.g., by deferring any necessary upgrades until just after the rent reset.

Any participation rent formula in a Lease might also award Landlord "transaction payments," i.e., a small percentage of capital transactions such as lease assignments, refinancings, or other transactions tantamount to either. Transaction payments seem particularly common in leases from governmental entities, where politicians worry about bad publicity if a developer realizes a "windfall" but the governmental entity receives nothing. In the author's experience, the legal fees that go into negotiating transaction payments typically exceed any payments to the governmental entity by the time the developer finishes claiming deductions.[17]

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obligations—it also sounds like a wonderful source of future business for litigators, consultants, expert witnesses, and appraisers. But maybe that's always true for any form of contingent rent adjustment.

[17] For a similar dynamic, see the entry on "Hollywood accounting" at www.wikipedia.org.

If Tenant agrees to pay Landlord transaction payments, then the principles and issues above will arise, including the risk of recreating the Internal Revenue Code. And, again, any uncertainty about line drawing or inclusions or exclusions will produce disputes down the line.

For example, does a "refinancing" include the case where Tenant holds its leasehold free and clear, and places an entirely new mortgage on the leasehold? Can it be a "re"-financing if no financing existed before the transaction closed? Does "refinancing" refer to placing any form of financing on an asset that had previously been financed in some other way at any time, or does it merely refer to replacing one mortgage with another mortgage, probably larger? Should Tenant's first construction loan be exempt from any payment to Landlord? First permanent loan? If multiple sales of the leasehold occur, should Landlord participate only in the "profit" since the last sale? What about multiple refinancings over time? If Landlord participates only in the "new loan proceeds," what if some of those loan proceeds arose only as a result of amortization of the previous loan? What if Tenant uses the proceeds to repay additional equity investment the project needed?

These questions only scratch the surface of the issues that can arise once Landlord and Tenant start down the percentage or participation rent road.

1.10. *Small Percentages—Not So Small.* Setting aside the many opportunities for dispute that arise in measuring any participation rent, even a very low percentage of Tenant's gross revenues can place a very significant burden on Tenant, giving Landlord a correspondingly significant stream of participation rent. Suppose, for example, that Tenant agrees to pay Landlord 3% of a truly gross measure of revenue, with no meaningful deductions at all. A payment of just 3% of gross sounds like a really small percentage.

Assume, however, that Tenant's operating expenses, real estate taxes, and insurance consume 50% of gross revenue. Assume ground rent consumes another 10% and debt service another 20%.

After those deductions, Tenant really gets to keep only 20% of its gross revenue. So Landlord's 3% share of that gross revenue represents almost one-sixth of Tenant's bottom line. Moreover, Tenant might operate at a loss even though gross revenue seems substantial. In other words, instead of adding up to 80% of gross revenue Tenant's expenses could add up to 105%.

In all these cases, paying even a very small percentage of gross revenue to Landlord can put quite a dent in Tenant's ultimate bottom line. Assuming Tenant will consider the concept at all, Tenant might respond in part by trying to credit one ground rent stream against another—similar to the operation of a natural breakpoint with percentage rent in a retail lease or a right for a space tenant to offset real estate tax escalations against percentage rent. Similar considerations arise if Landlord will receive a percentage of refinancings, lease assignment proceeds, or other capital transactions.

As a variation, the parties could conceivably measure Landlord's participation in Tenant's operating revenue based not upon Tenant's actual earnings, with all the headaches that entails, but instead based on how much Tenant reasonably "should have earned" based on market conditions at the time of determination.

If the project consists of an up-to-date office building, for example, the participation rent determination could assume Tenant achieves the same occupancy rate and rental levels as other comparable buildings in the market, and expense levels consistent with similar buildings. In each case, the measurement would disregard Tenant's actual financial performance. Tenant would then pay participation rent based on these benchmark market-based numbers.

Although this idea may sound practical or at least creative, the parties still must consider the possibility of future changes in circumstances, starting with a change of use of the building. And Tenant will worry that circumstances or issues peculiar to this property will prevent Tenant from achieving strong enough actual results to match the benchmark-based participation rent the Lease requires Tenant to pay. If the parties keep Landlord's participation low, dumb, and simple, then Tenant may be willing to live with that risk and the corresponding benefit Tenant will realize if Tenant produces results higher than the benchmark might suggest.

Yet another possibility: the developer might agree to give Landlord a small "carried interest" in the Tenant entity. Any carried interest will, however, raise another host of issues, some but not all of them variations on the problems discussed earlier. Many of the carried interest issues will arise because the developer will probably invest substantial additional capital to generate the anticipated value and return from the project. Another set of problems might arise from Landlord's concern that the developer could somehow redirect or dilute project income in a way that makes the carried interest worthless. Those two groups of issues only scratch the surface of what a carried interest might entail.[18]

Ground leases do occasionally provide for percentage or participating rent along at least some of the lines suggested above. Such provisions are, however, not common. They also create ample opportunity for new disputes.[19]

As yet another variation on the percentage rent arrangements suggested above, sometimes a Lease will periodically reset base rent taking into account Tenant's net operating income over some test period, e.g., Tenant's average net income during the three years before the reset. The base rent then increases to equal some percentage of net income, though the base rent can never go down. Although this makes sense and protects Tenant from unpleasantness, it also raises most

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[18] Many of these issues also arise in negotiating a joint venture. See Joshua Stein, Agenda for a Joint Venture Agreement, 56 The Practical Lawyer 36 (April 2010) (www.pdf2go.org/165.html).

[19] As one example, the author served as an expert witness in a dispute that arose over a similar participation arrangement, not involving payment of ground rent, where the payor wanted to set up huge reserves and subtract them before calculating participation payments. See *Building Service Local 32B-J Pension Fund vs 101 Limited Partnership*, N.Y. State Sup. Ct., Decision After Nonjury Trial, March 7, 2016 (Index No. 652266/2010).

of the same issues (discussed above) as any other method of rent adjustment that looks at Tenant's financial results.

If the parties do not want to agree to any form of participation ground rent, the question then becomes: how else can the Lease protect Landlord from inflation and equitably compensate Landlord, while protecting Tenant from destruction of its leasehold through an unaffordable rent increase?

1.11. *Other Indexes.* One might tie periodic major rent adjustments to an index. For example, rent might rise with the consumer price index. People in real estate, particularly lenders, have historically believed the CPI rises faster than real estate values and rents; hence, they may propose a cap on the adjustments.[20] But if the parties cap any periodic rent adjustment, then Landlord will not achieve its goal of protecting itself from inflation. Without a cap, though, Tenant may have trouble obtaining financing.

In the author's experience, Landlords and Tenants have recently been willing to live with uncapped CPI adjustments in place of land value resets.

Perhaps the parties can find an index better than CPI, published and reliably updated over time by some authoritative third party. Possibilities might include such measures as Class A office rents, average daily rate for hotel rooms in a certain market stratum, real estate tax assessments, or retail rents, in each case for some defined local geographical area and taking into account intended use (and any future flexibility in use) of the improvements. Real estate professionals may have varying degrees of confidence in any possible index. They would need to choose accordingly.

Based on this approach, future changes in the chosen index would drive changes in the ground rent, regardless of what a particular Tenant does or earns in the demised premises. Such an index could make sense, assuming it matches likely uses of the site. A combination of multiple indexes might also work, though it might not ultimately differ significantly from

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20 Historically, over any extended period CPI has actually risen only 2% to 3% a year, despite perceptions of wild inflation over many years. Some periods of very high inflation did occur, of course, and those made some old ground rents look silly. Looking back over the long term, though, CPI has not grown all that dramatically. It has certainly not been "out of control" over the long term or even the last 30 years. Commercial real estate values considered as a whole over the entire United States have trailed the CPI, except in Manhattan, where they have barely matched it over any extended period, and Washington, DC, where growth of the federal government may have led to land appreciation far beyond CPI growth. These statements are all wild overgeneralizations—they should not be relied upon in any way or even taken very seriously—but they do summarize the author's nonauthoritative but also nontrivial research in the area. Further insights on these crucial issues will be welcomed.

measuring participation rent based on a marketplace benchmark of what Tenant "should have earned," as suggested above.

As yet another alternative, a Lease could theoretically refer to some objective third-party index for long-term capitalization rates for real estate investments at the time of the rent reset. Any such index would need to reflect local market conditions; have a reasonable history; and have a high likelihood of surviving for multiple decades. Today such an index does not seem to exist.

Ground leases once required tenants to pay rent equal to the dollar equivalent of a certain amount of gold. The federal government outlawed such clauses in the 1930s as part of the New Deal. Gold clauses became legal again for any "obligation issued after October 27, 1977."[21] A federal court validated such a clause as recently as 2008.[22] Gold clauses certainly would have protected landlords from inflation in the recent past, at least until the price of gold dropped in the particularly recent past. Until that recent adjustment, in most of the last few decades, gold clauses would have produced dramatic rent increases given the ever-increasing dollar value of gold, i.e., the plummeting value of the dollar as against gold.

Tenants, however, would fear a disconnect between the price of gold and the "right" rent, in dollars, for a given site over time. During the last few decades, any such fear would have been entirely justified. Looking ahead, however, Landlord may worry that gold has run its course, or that during the Lease term gold might no longer function as a reliable repository of value. Landlord may also note that a gold clause has no particular correction with the future value of this particular site. Landlord might care more about that value than about the general value of the dollar.

To the extent that the parties agree on any index or other form of reference point, they have to worry about what might happen to it in the long lifespan of their Lease. If the index or reference point goes away, then Landlord will want the right to propose some reasonable substitute, but Tenant won't tolerate that level of Landlord control. Hence another dispute and another arbitration.

1.12. *Recalibration Of Relative Values.* The parties could also try to devise a rent adjustment structure in which, over time, Landlord and Tenant will each maintain a position whose value always equals about the same percentage of the value of the project as a whole. In other words, whatever rent reset formula the Lease used, it would contemplate a valuation of both Landlord's and Tenant's position, after taking into account the contemplated adjustment. Then the Lease would also add a requirement—and, to assure it, another step in the rent adjustment—that at the end of the day each party would maintain about the same percentage of the value of the project as a whole.

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21 31 U.S.C. § 5118(d)(2).

22 216 Jamaica Ave., LLC v. S & R Playhouse Realty Co., 540 F.3d 433, 441 (6th Cir. 2008).

For example, if the initial ground rent were calibrated to give Landlord a position worth 34% of the project as a whole, then any future ground rent would need to be calibrated to maintain that percentage, taking into account market conditions at the time of any rent reset. This approach would still require appraisals and the headaches and uncertainties they create. It would, however, at least address each party's fear that, over time, the rent adjustment would shift a disproportionate amount of value into the other party's pockets.

Although recalibrating relative values has a theoretical appeal to it, it is not at all market standard. In fact it is unheard of. And Tenant would point out that any such mechanism must also consider the additional capital investment Tenant will make in the project, to upgrade it and increase its value, or even just to keep it functional and rentable on attractive terms. If the property's value as a whole increases as a result of Tenant's investment and brilliant development, leasing, and management strategies, how does one slice up the resulting increase in value?

Landlord would respond by saying any such capital investment is part of what Tenant undertakes when signing a Lease. Tenant avoids the need to finance the cost of land acquisition, but in exchange bears the burden of paying ground rent and figuring out, over time, how best to exploit the real estate. That burden includes the obligation to make capital expenditures to keep the building up to current standards.

These issues become particularly troublesome if the Lease demises a vacant site. It may be easier in an existing building. But the issues involved may not be all that different from those arising whenever a Lease requires appraisal of anything other than the actual building (and underlying land) on the site at the moment of appraisal.

Because of the ever-shortening duration of the remaining Lease term, however, Tenant's leasehold estate is "supposed to" decline in value over time, requiring some further adjustment, particularly in the last few decades of the Lease term. This could take various forms—each with its own unique bundle of trouble—all beyond the scope of this article. Aspirin may help.

Instead of looking at relative shares of value, the parties might look at their relative shares of overall property income. The Lease might start out by providing for a fixed rental stream with fixed bumps. But it could also say that if Landlord's share of overall gross revenue (or, less desirably, net operating income before ground rent) ever drops below a certain percentage, then Landlord can require an increase in ground rent to bring that percentage back to a certain level. This approach is not too different from the percentage rent discussed earlier. It is also a variation on the technique of "debt service coverage ratio" from real estate financing, except it refers instead to a "ground rent coverage ratio," with the goal of keeping it within a certain band.

Conversely, if as a result of those increases in ground rent Landlord's share ever rose beyond a certain percentage of gross revenue, then ground rent would drop, but never below the fixed rent schedule. Arrangements like these can give Landlord a form of participation in future upside without opening up the possibility of making the leasehold estate uneconomic. But, like so many other alternatives discussed in this article, these arrangements come with tremendous definitional issues and, hence, both (a) the need for omniscience in considering all possibilities;

and (b) the risk of disputes. They tempt Tenant to game the system in any number of ways, while exposing Landlord to the risks of Tenant's bad business judgment. For example, Tenant might underinvest in the improvements, not keep up with their "highest and best use" or even just current industry standards over time, or allow them to become obsolete. Landlord typically wants none of that when signing a Lease.

As a more practical variation on this theme, the parties could agree that, after each rent reset, the value of Landlord's position must never exceed a certain percentage of the value of the whole asset (land and building, appraised as if the Lease did not exist), and also can never fall below some other percentage of that value. To adjust for the possibility of Tenant incompetence or dereliction, the value of the whole asset would need to disregard any loss of value resulting from Tenant's failure to comply with the Lease. This raises once again the issues of capital expenditures and mismanagement discussed above.

1.13. *Rent Adjustment Timing.* Anyone who negotiates future rent adjustments in a Lease should also consider how the timing of those rent adjustments interacts with the timing of Tenant's renewal options. In Tenant's perfect world, each rent adjustment period would correspond to an option term. Tenant would know the adjusted rent before needing to exercise a renewal option. As an equivalent alternative, Tenant could have the right to withdraw the exercise of an option if Tenant didn't like the rent as ultimately determined.

Both of those approaches, though perhaps typical, convert each option into a one-way negotiation in which the rent can only go down from whatever number the rent determination process produced. Of course, the leverage they give Tenant is roughly equivalent to Tenant's right to walk from the Lease at any time. That walk-away right always gives any Tenant the ability to try to negotiate the rent downwards at any time. The ability to not exercise—or withdraw the exercise of—a renewal option would create much the same leverage.

The dynamic changes, of course, if Tenant has significant credit or a creditworthy guarantor, or if credit enhancement measures, such as a security deposit or a letter of credit, back Tenant's obligations. In those cases, Tenant can't so easily threaten to walk away from the Lease, so Tenant truly realizes a benefit by knowing the adjusted rent before the deadline to exercise the renewal option.[23]

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[23] In a typical Lease, even a creditworthy tenant may not have much "walk-away exposure." Most leases, including ground leases, allow Landlord to sue a defaulting tenant for the excess, if any, of the reserved rental over fair market rental value for the remaining term, discounted to present value. Usually no such excess exists. The Lease has value to Tenant precisely because the ground rent is below fair market value. Thus Landlord cannot sue for a huge lump sum if a creditworthy tenant decides to walk. Landlord might mitigate that problem by making it clear that "fair market rental value" refers to just the land, not the entire "premises," but even then the land rent will often not exceed market rental value. In that case, to recover, Landlord may need to leave the Lease in place and sue monthly for unpaid rent—not too appealing. Perhaps Landlords should think more about

Footnote Continued on Next Page.

A more balanced approach might require Tenant to exercise each option before knowing the outcome of the rent determination process, with no right to withdraw the exercise of the option, only the right to walk away from the Lease—a right that Tenant typically has at all times after completion of construction. The renewal options would be disconnected from the rent determination or renegotiation process, putting the parties in the same position—and giving each the same leverage—as if the rent adjustment occurred part of the way through the Lease term, rather than as part of the renewal process.

Except for the possible need to conform to "tradition," it seems unnecessary and perhaps even inappropriate to tie the timing of rent adjustments to the timing of renewal options. In any case, it is not "obvious" that adjustment periods should conform to renewal terms.

1.14. *Valuation Date vs. Rent Reset Date.* As another timing issue, much less fundamental, any land value rent reset must define the effective date as of which any new land value will be determined. Will the appraisers use as a valuation date the same day the rent reset will become effective? In that case, the parties will very likely not know the new rent number as of the date the new rent becomes effective. That uncertainty creates a housekeeping issue, because the parties will need to determine how much interim rent Tenant must pay during the appraisal process and resolution of any possible dispute.

If the parties are far apart in any such dispute, the determination of interim rent could have significant practical economic consequences for the parties. It seems reasonable and "fair" to set interim rent as the average of the last proposals made by each party before the effective date of the rent reset. There are, of course, other ways to handle that issue, but it's something the parties should not overlook. This issue does not just represent a hypothetical eventuality. To the contrary, it's highly likely to arise, especially if the valuation date matches the first day of the rent reset.

To try to avoid that drama, the parties might agree upon a valuation date that is six months or longer before the effective date of the rent reset itself. That timing gives the parties a window in which to resolve their dispute—whether through negotiations or a complete appraisal or arbitration process—before the rent actually adjusts. If, however, one assumes that in the long run real estate values always rise -- typically 3% a year in the long run—an accelerated valuation date may deprive Landlord of the benefit of some real estate appreciation, though it also protects Landlord from a short-term decline in the market, if that occurs.

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the measure of damages for a Lease default. Of course, any Landlord might happily recover possession of a completed building (and sometimes a security deposit) and call it a day. That right gives a typical Landlord its best security for payment of ground rent, plus a graceful way to recover if Tenant decides to default. That statement applies, of course, only if the ground rent is significantly below market rental value for the land and improvements, and the improvements are in reasonable condition. If the "ground lease" originally demised both land and building, then Tenant might have no equity at all in the leasehold during a depressed real estate market.

The parties might, and usually do, ignore that issue, treating it as one of the consequences of having an agreed valuation date, an element of their business deal. Or they might agree that once the appraisers determine the land value as of the valuation date, landlord can require a slight adjustment (a percentage or two or something based on CPI) to account for appreciation that would have occurred from the land valuation date until the rent reset date. Most Leases contain no such adjustment. But any Lease should define the valuation date with absolute clarity and handle the likely circumstance where the rent is supposed to adjust before the new rent is actually determined.

1.15. *Real Estate Derivatives?* Landlords and Tenants might eventually hedge some risks of real estate inflation and ground rent adjustments through insurance or real estate futures markets, in much the same way farmers hedge commodity prices. But commercial real estate is not as fungible as pork bellies and corn. And, after some false starts with real estate derivatives during the boom that ended in 2008, it's safe to assume that brilliant new real estate derivative products are not at the top of anyone's list. Great financial minds may bridge part of that gap, perhaps by insuring against inflation through puts and calls involving long-term TIPS bonds. That too has its risks. And its transaction costs are likely to be high until a broad market emerges.

Lease negotiators typically worry that creative structures like those proposed in this article will not work right because of some problem or gap that no one notices until the litigation or arbitration begins and the parties and their counsel take out their magnifying glasses and apply them, and brilliant legal minds, to the Lease. It is a reasonable form of free-floating anxiety when trying to create something new and different that will work correctly for 99 years.

My own many recent experiences as an expert witness suggest that the commercial real estate industry and the lawyers who serve it overestimate categorically their own intelligence and ability to "get everything right" in the context of ever-more-complex deal structures and terms.[24] The more complex and creative the various gradations and nuances become, the more likely the parties will get them wrong or miss something that turns out to be crucially important. Problems seem particularly likely to arise if, for some reason that seems good at the time, the parties agree that the rent reset formula will change at some point in the distant future. The parties may forget about the change, or it may be negotiated and written at the last minute in a sloppy way. It also invites dislocation and disputes.

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[24] For more on this topic, see Joshua Stein, It's Complicated, But Is It Right?, The Mortgage Observer (monthly supplement to The New York Commercial Observer), February 2013, at 12 (www.pdf2go.org/100006.html). The author's expert witness assignments mostly involve complex and nuanced documents for large transactions. Aside from Leases, the line-up can include joint venture agreements; development agreements; intercreditor agreements; and loan documents, particularly nonrecourse clauses and carveouts. With the help of teams of great minds, these documents cover every possible eventuality perfectly—often in great detail and at great length—except, it seems, the one eventuality that actually occurs. Hence the litigation.

Complexity and sophistication of this type will leave land mines in a Lease, just waiting to produce unpleasant surprises when inspected under a high-powered microscope in a real world full of entropy and unanticipated possibilities. The incredibly complex language and multi-page sentences that are so common in today's real estate documents often manage to include some imperfection. All it takes is one imperfection to fuel years of litigation. And, whenever writers of legal documents try to use words to define some future hypothetical that is intended to replicate a set of present known conditions—pretty much what one does in any land valuation rent reset—the fallibility of lawyers often becomes particularly apparent. They try to think of everything but don't always succeed.

Legitimate fear of complexity, legitimate fear of change, and the constant need to satisfy future lenders will often drive Lease negotiators back to the traditional rent adjustment formula described at the beginning of this article, assuming Tenant and Leasehold Mortgagee are willing to accept any uncertainty at all.

They may prefer instead a much more dumb and simple approach: a fixed and defined stream of rent, so that an exhibit to the Lease lists each calendar year during the Lease term and then says how much rent Tenant must pay in that year. For example, in the year 2043, the rent will be $973,252. The rent can certainly rise over time, but each increase is scheduled and defined in advance. In the current market as of 2018, one would expect those fixed increases to equal 2% to 2.5% of the previous year's rent. That percentage is fairly consistent with long-term real estate appreciation, even in New York City. The result: a fixed and defined stream of payments, the equivalent of a long-term bond, with Landlord receiving back a building (for whatever that might be worth in its then-current condition) at the end of the Lease term.

Investors figure out how to value such bonds all the time, using whatever discount rate they think makes sense. Landlord might be willing to perform the same analysis, in effect trading its real property for a stream of bond payments. In a Tenant-friendly market, Landlord may have no choice if Landlord wants to make a deal. If the payments start out at an appropriate level and contemplate attractive periodic increases, the transaction just might make sense for Landlord. And it should produce ecstasy for Tenants and Leasehold Mortgagees, who can figure out exactly what they are getting into without the risk of surprises in future years. If, however, Landlord wants to "stay in the real estate business," a fixed rent schedule won't have much appeal.

1.16. *Lessons Learned.* Anyone negotiating a Lease may want to keep in mind these lessons distilled from the preceding article:

- *Industry Standard*. The industry standard, at least in New York City, remains: (a) small bumps every year or few years; and (b) a reset to 6% or 7% of land value (or perhaps a slightly lower percentage) every two or three decades.

- *Not "Subject to Terms of Lease."* Don't try to value the land "subject to the terms of the Lease." Instead, define what assumptions you want the appraisers to use. Which restrictions in the Lease should the appraisers consider?

- *Simple*. Whatever you do, try to keep it simple. Test it. If your language contemplates an appraisal, ask an appraiser to look at it. Make sure your language will allow the appraisers to do their job without getting confused.

- *Overthinking, Future Changes.* Resist the urge to overthink and make your rent reset formula overly nuanced. It often won't play well two or three decades from now. That's especially true if you agree that the formula will change in some way in the distant years.

- *Percentage Rent.* Percentage or participation rent can sometimes work but, again, try to keep it simple with as few deductions and variables as possible. Take a small percentage of a big number. Test your formula carefully.

- *Fixed Rent.* Don't rule out the possibility of a fixed rent schedule, with fixed bumps. Lenders love it. With the right numbers and the right discount rate, it may work for Landlord too.

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SAMPLE ARBITRATION LANGUAGE[1]

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For reference and possible use in transactions, we offer four samples of possible arbitration language. The first two samples are primarily intended for ground leases with possible rent resets based on Land Value. The third sample sets out a simpler process for other disputes, typically of lesser magnitude, e.g., reasonableness of withholding consent. The fourth sample is specific to arbitration where the parties cannot agree on the final form of documents for a transaction. We encourage anyone using this language to: (a) review all four options and use whatever provisions they think will work best for their particular situation; and (b) make sure all capitalized terms have been appropriately defined taking into account the overall document.

1. LAND VALUE ARBITRATION (OPTION 1)

1.1. *Definition.* "Land Value" means, on each Land Value Reset Date, the fair market value[2] of the Land at that Land Value Reset Date, determined under this Article.

1.2. *Agreement and Arbitration.*[3] The parties shall try to agree on Land Value at least __ months before each Land Value Reset Date. If they do not agree by that date, then either shall Notify the other of the impasse. Each party shall within 10 Business Days after the effective date of that Notice designate an Arbitrator, who need not be Disinterested. All appointed Arbitrators shall be MAI appraisers with at least 10 years' experience appraising properties within the market in which the property is located. Those two party-appointed Arbitrators shall within 10 Business Days designate a third Arbitrator, who must be Disinterested. If the two party-appointed Appraisers cannot agree on the appointment of a Disinterested Arbitrator, they shall apply to the AAA or any successor organization for the appointment of a Disinterested Arbitrator, but the AAA arbitration rules and procedures will be not be used and instead, the arbitration rules and procedures set forth in this Lease shall govern. The Arbitrators shall hold

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[2] We omit possible details about the definition of Land Value, as this program relates to arbitration, not the nuances of Land Value

[3] Alternatively, the parties can agree to the appointment of Appraisers for an appraisal proceeding. In an appraisal proceeding, the parties are not entitled to an arbitration hearing, and do not have the right to present witnesses or evidence or be represented by counsel, all of which they are entitled to in an arbitration. A Land Value determination by Appraisers will work about the same as the arbitration procedures described in text, substituting appraisers for arbitrators.

hearings within [90 days] of the appointed of the Disinterested Arbitrator. All three Arbitrators must agree in writing to determine Land Value in good faith in accordance with this Article. The Disinterested Aribtrator shall select the Final Fair Market Value Determination of either Landlord or Tenant that the Disinterested Arbitrator believes is closest to Fair Market Value, and nay not select any other amount as the Fair Market Value. The parties shall confirm that selected Fair Market Value in writing.

1.4. *Failure to Designate.* If either party fails to timely designate an Arbitrator, and does not cure that failure within 10 Business Days after Notice from the other party, which Notice states in capital text "**FAILURE TO TIMELY DESIGNATE AN ARBITRATOR SHALL RESULT IN FORFEITURE OF THE RIGHT TO NAME AN ARBITRATOR AND AN ARBITRATOR SHALL BE APPOINTED ON YOUR BEHALF**," then the one designated Arbitrator shall appoint the Arbitrator for the other party.

1.5. *Delegation.* Landlord and Tenant may each, by Notice to the other, delegate to one Mortgagee all its rights under this paragraph. That delegation shall: (i) bind the recipient of the delegation Notice; and (ii) remain effective until the designated Mortgagee has either satisfied and discharged its Mortgage of record or given Notice terminating the delegation.

1.6. *Disinterested.* "Disinterested" means collectively, (i) having no economic interest, direct or indirect, in the Land, the Improvements, or any property or business owned in whole or in part by Landlord or Tenant; (ii) not being a partner of, or employed by the same firm as, any nominee selected by Landlord or Tenant; (iii) not being an officer, director, employee, partner, manager, member, shareholder, or other similarly positioned individual of Landlord, Tenant, or any Affiliate of either at the time in question or any time within the previous five years; (iv) not having been an agent or adviser of Landlord, Tenant, or an Affiliate of either in those five years; and (v) not being related, within six degrees of consanguinity, to anyone listed in clauses (i) through (iv).[4]

2. LAND VALUE ARBITRATION (OPTION 2)

Experienced litigators tend to prefer JAMS arbitration over AAA arbitration except for valuation disputes, where AAA typically has a better roster of appraisers. The AAA rules are, however, often regarded as cumbersome and the administration process can be extremely slow.

Here is an example of arbitration procedures for a fair market value determination:

2.1. *Initial Meeting.* Within 30 days after the appointment of the third arbitrator, the three arbitrators will meet (the "Initial Meeting") and set a hearing date for the arbitration. The hearing shall not exceed five days and shall be scheduled to be held within [90/120] days after

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[4] This sets a rather high standard, perhaps an unrealistic one, if Landlord or Tenant is a major player or even a somewhat active player.

the meeting of the three arbitrators. At the Initial Meeting, Landlord and Tenant shall each submit a Fair Market Value determination (each, a "Final Determination"). If either party shall fail so to submit a Final Determination, then the other party's Final Determination shall be selected as the Fair Market Value.

2.2. *Arbitration Procedures.* There shall be no discovery in the arbitration. [For space leases: However, on reasonable notice to the other party, Tenant may inspect any portion of the Building relevant to its claims, and Landlord may inspect any portion of the space occupied by Tenant on the floors in issue.] The Disinterested Arbitrator shall establish a schedule prior to the scheduled hearing for the parties to exchange opening written expert reports and opening written pre-hearing statements, rebuttal written expert reports and rebuttal written pre-hearing statements, exchange of written witness lists, including a brief statement as to the subject matter to be covered in the witnesses' testimony, and to exchange all documents that they intend to offer at the hearing. Other than rebuttal witnesses, only the witnesses listed on the witness lists shall be allowed to testify at the hearings. Each party may present live witnesses and offer exhibits, and all witnesses shall be subject to cross-examination. The Arbitrators shall conduct the five day hearing so as to provide each party with sufficient time to present its case, both on direct and on rebuttal, and permit each party appropriate time for cross examination; provided, that the arbitrators shall not extend the hearing beyond five days. Each party may, during its direct case, present evidence in support of its position and in opposition to the position of the opposing party.

2.3. *Decision.* Following the conclusion of the hearings, the three Arbitrators shall meet and within 10 Business Days following the conclusion of the hearings, the Disinterested Arbitrator shall make a determination of the Fair Market Value by selecting either the amount set forth in Landlord's Final Determination or the amount set forth in Tenant's Final Determination, whichever the third arbitrator determines is closest to Fair Market Value of the Land, and may not select any other amount as the Fair Market Rent, provided that in no event shall the rent be less than the Annual Rent. The Disinterested Arbitrator need not issue a "reasoned award" or any explanation of his or her determination. The fees and expenses of any arbitration pursuant to this Section shall be borne by the parties equally, but each party shall bear the expense of its own arbitrator, attorneys and experts and the additional expenses of presenting its own proof. The arbitrators shall not have the power to add to, modify or change any of the provisions of this Lease. After a determination has been made of the Fair Market Value, the parties shall execute and deliver an instrument setting forth the rent based on the Fair Market Value, but the failure to so execute and deliver any such instrument shall not effect the determination of the rent based on Fair Market Value.

3. GENERAL ARBITRATION LANGUAGE (NOT SPECIFIC TO FAIR MARKET VALUE)

3.1. *Use of Arbitration.* Only where this Lease states that any disagreement or impasse shall be resolved through Arbitration (an "Arbitrable Matter"), that Arbitrable Matter, including the scope of any Arbitrable Matter and whether an asserted Arbitrable Matter in fact qualifies as such, shall be determined by arbitration in New York City before one arbitrator ("Arbitration"). The Arbitration shall be administered by JAMS Alternative Dispute Resolution Services in the City of New York (with any successor organization, "JAMS") under its Streamlined Arbitration

Rules & Procedures, effective July 1, 2014, as amended. [JAMS Rule 28 (baseball arbitration) shall apply

3.2. *Procedural Matters.*In any Arbitration: (a) the arbitrator shall have no right to award damages on account of any unreasonable or allegedly unreasonable withholding of any consent where that withholding is an Arbitrable Matter; and (b) the decision and award of the arbitrator shall be final and conclusive on the parties. The parties consent to entry of judgment based on that award. The party whose position the Arbitrator rejected shall pay all costs and fees, including reasonable attorneys' fees, of both parties in the Arbitration unless the Arbitrator finds that neither party prevailed.[5] The Arbitration shall be confidential. The parties shall preserve its confidentiality. Except as this Lease states, the Arbitrator shall establish the Arbitration rules of procedure. If any party fails to appear at a duly scheduled and noticed hearing, the arbitrator is hereby expressly authorized to enter an award for the appearing party. This Arbitration clause shall not preclude anyone from seeking provisional remedies in aid of Arbitration from a court. If JAMS (and any successor organization) no longer exists, then Landlord shall reasonably designate a replacement.

4. ARBITRATION FOR DISPUTES ON FORM OF DOCUMENTS

4.1. *Efforts to Agree.* Landlord and Tenant shall use commercially reasonable efforts to agree on a final form of the Documents, on or before [DATE] (the "**Arbitration Date**").

4.2. *Submission of Dispute.* If the final form of the Documents is not agreed to by both parties on or prior to the Arbitration Date, either party shall submit a dispute relating to the documentation that has not been finalized to final and binding arbitration in New York, New York administered by JAMS in accordance with JAMS Streamlined Arbitration Rules and Procedures in effect at that time (or, if JAMS is no longer in existence, then administered by National Arbitration and Mediation ("**NAM**"), in accordance with NAM's Comprehensive Dispute Resolution Rules and Procedures; and if NAM is no longer in existence, then administered by any successor or substantially similar dispute resolution organization). A single arbitrator will be selected pursuant to such rules and procedures (the "**JAMS Arbitrator**").

4.3. *Arbitration Procedure.* The parties agree that: (1) the unsuccessful party in such arbitration will pay to the successful party all reasonable attorneys' fees and disbursements incurred by the successful party in connection with such arbitration, and will pay any fees and disbursements due to JAMS (or the organization administering the arbitration) and the JAMS Arbitrator and, to the extent the "successful" party cannot be clearly identified, each party will bear its own costs and expenses and the parties will pay their equal share of any fees and disbursements due to JAMS (or the organization administering the arbitration) and the JAMS Arbitrator; (2) arbitration pursuant to this Section is intended to be the sole and exclusive method of arbitration to be utilized by the parties and the sole and exclusive dispute resolution method to

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[5] Clients often have strong views on attorneys' fees clauses.

be utilized by the parties concerning any dispute regarding the final form of the Documents; (3) the JAMS Arbitrator shall have no right to award damages; (4) Landlord and Tenant shall submit to such binding arbitration only the terms and conditions of the relevant documents as to which there is a dispute (the "**Disputed Terms**") and all terms and conditions of the relevant documents not submitted to arbitration (the "**Undisputed Terms**") shall be deemed to be irrevocably agreed upon by Landlord and Tenant, (5) the JAMS Arbitrator shall follow the [provisions of the Term Sheet [or other document governing the purpose of the disputed documents][6], and (6) any decision or award rendered in such arbitration, whether or not such decision or award has been confirmed, shall be final and binding upon Landlord and Tenant and shall constitute an "award" by the JAMS Arbitrator within the meaning of the applicable arbitration rules and Laws. Each party shall submit to the JAMS arbitrator, with respect to each Disputed Term, the language proposed by such party for the Disputed Term (the "Proposed Term"). The JAMS Arbitrator shall determine the Disputed Terms on an issue by issue basis, and shall order, with respect to each Disputed Term, that the parties enter into the Proposed Term submitted by either Landlord or Tenant as to that specific issue, and shall not modify the Proposed Term submitted by the prevailing party as to such issues.

4.4. *Limitations.* The JAMS Arbitrator will be bound by the provisions of this Lease and will not have the power to add to, subtract from or otherwise modify such provisions or any of the Undisputed Terms. The JAMS Arbitrator will consider only the specific Disputed Terms submitted to him/her for resolution, and will be directed to make a determination as to the "successful" party or a specific determination that there is no prevailing party. If any party fails to appear at a duly scheduled and noticed hearing, the JAMS Arbitrator is hereby expressly authorized to enter judgment for the appearing party. The JAMS Arbitrator need not issue a "reasoned award" or provide an explanation of his/her decision. Landlord and Tenant shall each have the right to appear and be represented by counsel before the JAMS Arbitrator and to submit such data and memoranda in support of their respective positions in the matter in dispute as may be reasonably necessary or appropriate under the circumstances. Neither party shall have ex parte communications with any arbitrator selected under this Section [__] following his or her selection and pending completion of the arbitration hereunder.

4.5. *Arbitrator Standards.* Any JAMS Arbitrator acting under this Section [__] shall (1) be experienced in the field to which the dispute relates, (2) have been actively engaged in such field for a period of at least 10 years before the date of his or her appointment as a JAMS Arbitrator hereunder, (3) be sworn fairly and impartially to perform his or her respective duties as a JAMS Arbitrator hereunder, (4) not be an employee or past employee of Landlord or Tenant or of any other person, partnership, corporation or other form of business or legal association or entity that controls, is controlled by or is under common control with Landlord or Tenant and (5) never have represented or been retained for any reason whatsoever by Landlord or Tenant or any

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[6] If no such document exists, the Lease should state the standards the Arbitrator should apply in choosing between the parties' submissions.

other person, partnership, corporation or other form of business or legal association or entity that controls, is controlled by or is under common control with Landlord or Tenant.

4.6. *Cooperation.* Landlord and Tenant agree to sign all documents and to do all other things necessary to submit any such matter to arbitration and further agree to, and hereby do, waive any and all rights they or either of them may at any time have to revoke their agreement to submit to arbitration and to abide by the decision rendered.

Topic II

Work Letters or What Leasing Lawyers Need to Know About Design and Construction Agreements

By Keith Reich, Esq.

WORK LETTERS OR WHAT LEASING LAWYERS NEED TO KNOW ABOUT DESIGN AND CONSTRUCTION AGREEMENTS

By

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I. WHAT IS A WORK LETTER

1. Purpose of Work Letters

   (a) vs. "as-is

   (b) Describes Landlord's Work

   (c) Triggers Commencement Date, i.e., substantial completion of Landlord's Work

   (d) Sometimes describes procedures for approving Tenant's Work, particularly if Landlord will be performing Tenant's Work

2. Types of Work Letters

   (a) Simple narrative, i.e., detailed scope of work

   (b) Plans and specifications – Complete set of construction drawings

   (c) Plans and specifications – To be prepared

   (d) For existing building

   (e) For new construction/major renovation

3. Difference between a Work Letter and an Alterations provision

II. DESCRIPTION OF LANDLORD'S WORK

1. Scope of Work/Narrative – Issues, e.g., lack of specificity and detail

2. Plans and specifications to be prepared by Landlord

   (a) Based on scope of work, preliminary drawings, etc.

   (b) Mechanism for preparation, submission to Tenant, approval/rejection by Tenant, etc. – time periods, basis for approval/rejection, deemed approval, etc.

3. Complete set of plans and specifications as a Lease exhibit

4. Modification of plans and specifications after completed/approved

(a) By Landlord, e.g., requirements of law, field conditions, errors & omissions

(b) By Tenant, e.g., changes to accommodate Tenant's installations

III. SUBSTANTIAL COMPLETION

1. Definition – Exclude long lead items, items that shouldn't be completed until after completion of Tenant's Work, accelerate substantial completion date/commencement date for Tenant Delays for purposes of rent commencement (but not for satisfying Landlord's obligation to complete Landlord's Work), certification by Landlord's architect and/or by Tenant's architect, etc.

2. Notice of Substantial Completion – Timing (before or upon actual substantial completion), preliminary notice, conclusive and binding notice;

(a) Punch-List – Notice, Landlord's obligation to complete, time period for completion, coordination with performance of Tenant's Work, etc.

(b) Exceptions to Tenant's acceptance of substantial completion (or for an "as-is" provision - Latent defects, seasonal issues, Landlord's ongoing maintenance and repair obligations

3. Disputes – Time period for inspection and notice of dispute, resolution of disputes (e.g., expedited arbitration, one arbitrator from pre-approved list, prevailing party attorneys' fees)

4. Other Conditions for Substantial Completion/Trigger of Commencement Date - Premises to be in legal compliance (including ADA for Landlord's Work), Premises to be broom-clean, vacant, etc., Building systems in good working order, no violations that would delay Tenant's Work or use of Premises

(a) For New Construction - Removal of scaffolding, hoists, construction shanties, etc., Building/common areas in legal compliance, including ADA

(b) Rights of Re-measurement for new construction

5. Late Delivery – Preliminary Outside date; final Outside Date, damages and right of termination

(a) Tenant delays - notice requirement

(b) Force majeure - limitation on period

(c) Reimbursement of expenses

(d) Self-help right

(e) Landlord right of termination

IV. PRE-COMMENCEMENT ACTIVITIES

1. Doesn't trigger Commencement Date

2. Interference with Landlord's Work - Priority for freight elevator, loading dock, hoists, etc., Tenant Delay]

V. OTHER LANDLORD'S WORK ISSUES/NEW CONSTRUCTION/WORK LETTER

1. Appoint construction representatives - to give notices, attend meetings, etc.

2. Require attendance at regular construction meetings

3. Benchmark/Milestone Dates - construction loan closing, building permits, demolition, excavation/foundations, Building skin, topping off, etc.

4. Separate sign-off for "substantial completion" of each item of Landlord's Work

5. Partial delivery of multi-floor premises

VI. TENANT'S WORK

1. Different procedure/time period for submission/approval of Tenant's plans

   (a) No approval – cosmetic/decorative; below certain dollar amount (CPI adjustment); no requirement of governmental approval or plan submission

   (b) No deemed approval for structural alterations

   (c) Reasonable approval – non-structural; no (adverse) impact on Building systems; limited to interior

   (d) Sole discretion – structural; impact on Building systems; outside the Premises

      (i) Exceptions to sole discretion – minor core drilling; supplemental hvac, generators, rooftop equipment, internal staircases, etc.

   (e) Pre-approval of plans/scope of work

2. Providing Building services

   (a) After Commencement Date, subject to completion of Tenant Work - distribution of electrical work, plumbing, hvac ducts

(b) Temporary services during Tenant's Work - electricity, a/c in summer for millwork, toilets, etc.

3. Tenant Improvement Allowance

(a) Tenant performing Tenant's Work vs. Landlord performing Tenant's Work

(b) Soft-cost; ff&e

(c) No Tenant default/cure default

(d) Upfront payment vs. progress payments vs. payment upon substantial completion

(e) Tenant's money first vs. Landlord's money first vs. pari passu

(f) Timing of payments/conditions to payments - paid vs. unpaid invoices, lien waivers/in lieu of lien waivers, certificates of architects, inspections, etc.]

(g) Retainage/reduction of retainage

(h) Final payment/conditions

(i) Time period to use allowance

(j) Unused allowance

(k) Landlord's failure to fund - offset rights, limitation on amount of monthly deductions, right to dispute, interest

4. If performed by Landlord with Landlord's Work

(a) Timetable for submission of plans and specifications and revisions (if applicable)

(b) Change orders

(c) Requirement to bid

5. If performed by Tenant

(a) Union vs. non-union

(b) Noise/construction during business hours

(c) Use of freight elevator/loading dock

(i) Staging of materials - sidewalk, interference with access and other tenants

(ii) Minimum required hours

(iii) Free after-hours use

(d) Approval of contractors - pre-approval, reasonable approval, deemed approval, reasons for disapproval, e.g., bankruptcy, problems in Building or other Landlord affiliate owned buildings, felony convictions

6. Additional security for Tenant's Work/Alterations - l/c, guaranty, threshold amount (subject to CPI adjustment), net worth test

7. Cooperation of Landlord

(a) Execute permit applications - including prior to plan submission and approval

(b) Access to Building plans

(c) Access to other portions of Building/other tenant space

(d) Use of Landlord's hoist/right to install Tenant hoist (new construction)

8. After completion of Tenant's Work/Alterations

(a) Close permits

(b) Sign-offs

(c) As-built plans

(d) No liens, violations, etc.

VII. MISCELLANEOUS ISSUES

1. Exceptions in SNDA for completing Landlord's Work, funding TI allowance, permitting offsets

2. Landlord security/guaranties

3. No sale of Building until construction is completed and fully operational

Topic III

Economics of the Deal

By

Eric G. Menkes, Esq.

Current Economics of the Deal

By Eric Menkes, Esq.

Wednesday October 10, 2018

11:25 am – 12:15 pm

- Understanding Net Effective Rent
  - Landlord Costs: Landlord Work; TI Allowance; Free Rent; Brokerage Commission
  - Example: $80/sf base rent; 20,000sf; 10 year deal; 6 months free; $70 TI allowance.
  - Net Effective Rent is $1,600,000/yr or $16,000,000 less $800,000 less $1,400,000, which equals $13,800,000= $69/sf
  - Plus (x) Landlord Work, and (y) Brokerage Commission of $768,000 [1.5 x 32% x $1,600,000] or $3.85/sf

- Understanding Cap Rates
  - What Is Cap Rate? Percentage Return on Investment
  - Cap Rate = NOI/Value
  - Lower Cap Rate = More Stable Asset/Stronger Market
  - Example: $1,000,000 with a 5% Cap Rate = $20,000,000 in Value

- Buying up the Rent Stream: Taking advantage of low cap rates
  - $10 million in TI Allowance = $20 million in value.
  - Should buyer/lenders be looking at the NOI or the Net Effective Rent?

- Breaking Down the Costs of Ownership
  - Operating Expenses are $15/sf and Real Estate Taxes are $13/sf. So Net to Landlord is $52.

- Operating Escalations versus Percentage Increases
  - 2.5% of $80 [$2/sf] versus 5% of $15 [$0.75/sf]
  - Issues: (i) When To Add In Interval Step Ups; (ii) Should they apply during renewals?; (iii) Exclude from Brokerage Commissions

- Understanding Percentage Rent
  - Percentage Rent is Street Retail Trend Today
  - Natural Breakpoint = Minimum Rent divided by Percentage Rent Rate
  - Example: $1,200,000 Minimum Rent, 6% Percentage Rent Rate. Breakpoint is $20,000,000.

Topic IV

Omni-Channel Leasing

By
Nina Kampler, Esq.

BRICKS MEET CLICKS: HOW OMNICHANNEL RETAIL IS IMPACTING LEASING FUNDAMENTALS

Presented to
New York State Bar Association
Real Property Law Section, Commercial Leasing Committee
October 10, 2018

By
Nina L. Kampler
President, Kampler Advisory Group, in strategic alliance with Hilco Real Estate
nina@kampleradvisorygroup.com

I. HISTORICAL CONTEXT OF RETAIL LEASING

Retail is as ancient as humanity and civilization, but was historically limited to a set physical location. Out-of-store retail was inaugurated with catalog sales in the late 1800s when Sears and Roebuck issued their first catalog. And for the next hundred years, retail was transacted either at a specific store or through a catalog sale, with an order placed by mailing it or on the phone. In the early 1990s, with the advent of safe encryption of credit cards, early experimental online sales began to take root. The founding of Amazon in 1994 completed the stage for the dramatic revolution that has drastically changed ---and continues to change ---the way we shop today.

The retail real estate legal community was initially concerned with how this would play out. With rent valuations traditionally based on sales origination, and calculation of gross sales and ensuing percentage rental stream to landlords, how would online sales change this structure? Yet early confusion quieted down: the volume of online transactions was not transformative. Ecommerce was somewhat limited to books and music, tangible goods easily acquired at a desktop computer. The traditional shopping patterns stuck, with online just another venue to purchase certain categories of goods.

However, the confluence of three elements in 2007 and 2008 created the perfect storm for enormous change: sophisticated digital technology, a drastic recession, and the computer-era purchasing demographic combined to significantly modify shopping behavior.

First, the creation of the iPhone in 2007 was the catalyst for rapidly advancing mobile technology, and opened channels for smarter, faster, targeted, and interactive e-tail.

At around the same time, another transformative—or rather cataclysmic --event occurred that also rocked the retail world: the global economic meltdown that heralded seismic shifts in our retail real estate landscape. Within a few years, thousands of stores shuttered, entire silos of concepts died, and the reshaped environment became populated by stronger retailers who used this recession to curate their brands.

And thirdly, the emergence of the millennial class (roughly defined as 18 to 35-year-olds) translated to a preference for digital shopping for the instant gratification generation. Constituting approximately one quarter of the US population, this powerful segment has demonstrated that we can shop with our fingers rather than our feet.

Today, peering through the rearview mirror affixed to the forward-looking retailer, the Great Recession was good for the state of retail. It weeded out the weak performers and forced brands to focus on their core merchandise and to listen to the customer. The retailers that learned this lesson quickly, who nimbly shed underperforming locations, shelved obsolete concepts, and shrank real estate footprints, are still alive and more likely to be expanding again. Chasing square footage to keep Wall Street happy proved cannibalistic and fatal. The revitalized retailer is dealing with an altered reality.

Clearly we prefer fewer and better choices and focused merchandising. The increasingly urbanized American customer wants to explore and to shop. But we have voted that we are reluctant to part with our money for something unless it delivers, at a bare minimum, either true value or a transcending experience. And the smart retailer completely understands that.

Same store sales, especially with hard goods and specialty apparel, continue to experience muted growth across all channels. Even luxury players, who were responsible for much of the success of urban retail during the period from 2010 through 2015, have been experiencing setbacks these last few years---as a result of international exchange rates favoring the US dollar, stratospheric real estate valuations in New York City and other high-street gateway marketplaces, and more cautious spending behavior. Fortunately for the retail real estate industry, there are current indications that some of the malaise that struck the luxury sector has begun to ease.

Online shopping concomitantly continues to grow exponentially, fueled by mobile apps and morphing technology, and the looming threat to render certain physical establishments irrelevant is not being diminished. Both the size and the sheer number of retail real estate brick and mortar establishments will continue downsizing for the foreseeable future.

What survives and thrives is the retailer that embraces our new Omnichannel universe and incorporates the reality of today in its strategic business planning.

Often, the best use of brick and mortar space is as a showroom: a space to see it, touch it, try it. Or the store may in fact be the space to return goods ordered on an IPad on the couch and delivered by FedEx that the consumer can't bear to rebox, giving the retailer the old-fashioned chance to capture the customer's fancy and transact a serendipitous sale. Savvy retailers know that no merchandise, no matter how spectacularly displayed, can be truly amazon-proofed. Yet, certain classifications require a store setting---a computer can never hand you a glass of wine, and our technology does not yet allow a prospective purchaser to feel the soft fibers of cashmere through a screen. What has emerged is the world of Omnichannel where the silos of bricks and clicks sit not side by side, but integrated as an organic whole.

The interplay between internet and storefront sales, when properly crafted, creates a synergy that results in a sum greater than its separate parts. A synthesized understanding of the offline and online customer delivers a seamless Omnichannel experience that reinforces loyalty and motivates the consumer to shop. Great brands figure this out. No one wants to enter retail space and be accosted by register sheriffs, as the roaring success of Apple demonstrates that an interactive open environment without the irritants results in increased sales. Instant gratification and paperless tracking are now expected.

In fact, we now know that successful Omnichannel has become the new driver of bricks and mortar, not its death knell. Warby Parker, Bonobos and Birch Box are illustrative examples of innovative on-line concepts that have morphed into successful Omnichannel retailers. They began as a fresh way for consumers to order product on line to satisfy a market that previously did not exist, but they have partially transformed into brick and mortar establishments by understanding the customers' need for real space to try on and experiment.

These traditional on-line only retailers did not merely open stores to afford their shopper a chance to shop, but rather, seized on specific consumer demand for showroom space to test and try on merchandise in a physical setting. The key to their critical success is seamlessly blending the on-line and in-store experience to provide optimal ease and accessibility of product. We are living in a universe that is the convergence of internet media and actual physical space.

Retail CFOs and General Counsels must now confront and grapple with such issues as when is the sale recognized, where the revenue is recorded, what are the best return policies and procedures and of course who gets credit for the sale. The very existence of these issues means that the wise company has embraced Omnichanneling retailing in order to cultivate and retain its customers. Whether bricks and mortar is a store or a showroom may be irrelevant when four-wall profit is no longer the barometer of success and percentage rent

calculations are rendered moot with new business modeling. And our Lease documents must contemplate this new reality and be drafted for the future that is now.

II. RECRAFTING KEY LEASE PROVISIONS

There are several sections of the lease that should be reevaluated as Omnichannel expands and matures. Most obviously gross sales inclusions and exclusions for the calculation of percentage rent must be adjusted to reflect retailers accounting and landlord's interests. Other sections of the lease, such as operating requirements, radius clauses and kickouts are also ripe for reconsideration.

Percentage Rent

Gross Sales Definition: Maximizing retailer success means maximizing sales from all pathways and insuring that they are mutually complimentary. Traditionally, Gross Sales have been a narrow measure of one store's success. If percentage rent is tracking real success, the definition of Gross Sales needs to change with the changes in retailer operation.

TRADITIONAL RETAIL LEASE CLAUSE	OMNICHANNEL FRIENDLY LEASE CLAUSE
Gross Sales: the entire amount of the actual sales price, whether wholly or partly in cash or for credit, of all merchandise sold, and the charges for all services performed at, in, or from the Demised Premises, including without limitation, all sales by any sublessee, licensee or concessionaire at, in, or from the Demised Premises.	Gross Sales: the entire amount of the actual sales price, whether wholly or partly in cash or for credit, of all merchandise sold, delivered, mailed, fulfilled, ordered and the charges for all services performed at, in, from, upon or through the Demised Premises, including without limitation, all sales by any sublessee, licensee or concessionaire at, in, from, upon or through the Demised Premises. Internet sales whether made from a mobile, stationary, store or customer-owned device, shall be counted as Gross Sales from the Demised Premises if either the device on which they are made or the location of the product from which they are fulfilled is the Premises. Additionally, all internet or mobile application or like sales made following access from a link from the Center or Landlord website shall be considered Gross Sales.
Exclusions: There shall be excluded from Gross Sales, as applicable: …(a) the exchange or transfer of merchandise between stores or warehouses of Tenant, between stores or warehouses of any subtenant, licensee or concessionaire, or between stores or warehouses of Tenant or any subtenant, licensee or concessionaire and stores or warehouses of their respective affiliates (including any parent, subsidiary or controlling corporation), when such exchange is made solely for the convenient operation of the business of Tenant of such subtenant, licensee, concessionaire or affiliate and not for the purpose of consummating a sale at, in, from or upon the Demised	Exclusions: There shall be excluded from Gross Sales, as applicable: … (a) the exchange or transfer of merchandise between stores or warehouses of Tenant, between stores or warehouses of any subtenant, licensee or concessionaire, or between stores or warehouses of Tenant or any subtenant, licensee or concessionaire and stores or warehouses of their respective affiliates (including any parent, subsidiary or controlling corporation), when such exchange is made solely for the convenient operation of the business of Tenant of such subtenant, licensee, concessionaire or affiliate and does not avoid the inclusion of a sale in Gross Sales which otherwise would be so included, … (b) cash or credit refunds, but only to the extent that the merchandise sold, was

Premises, … (b) cash or credit refunds, but only to the extent that the merchandise sold, was originally included in Gross Sales, … (c) delivery charges and wrapping charges where such service is provided at cost for the convenience of Tenant's customers,… (d) proceeds of vending machines that are used exclusively by Tenant's employees, and not situated on the sales floor area), … (e) workroom or alteration charges, …(f) mail order sales if the order relating thereto is not received, placed or filled at the Demised Premises.

originally included in Gross Sales (returns of internet sales which are then exchanged for or fulfilled by store product shall be included in Gross Sales), …, (c) delivery charges and wrapping charges where such service is provided at cost for the convenience of Tenant's in-store customers wrapping of internet product in-store shall be included in Gross Sales, … (d) proceeds of traditional product containing vending machines that are used exclusively by Tenant's employees and do not contain product sold on the store sales floor, and are not situated on the sales floor area, …(e) workroom or alteration charges except if performed on merchandise not physically purchased from the store or otherwise included in Gross Sales,… (f) mail order or internet sales only if the order relating thereto is not received, placed or filled at the Demised Premises.

EXISTING TENANT STORE LANGUAGE

"**Gross Sales**" means the aggregate amount, expressed in dollars, of all sales of goods, whether in full or discount prices or for cash or credit, made in, on, or from the Premises by Tenant, provided, however, that the following shall be excluded or deducted from Gross Sales:

(A) all credit, refunds, and allowances granted to customers;

(B) exchanges of merchandise between Tenant's warehouse or other stores and other similar movements of merchandise;

(C) returns;

(D) the proceeds from vending or other machines and commissions on such proceeds;

(E) delivery charges;

(F) internet or catalog sales.

REVISIONS TO REALIGN WITH PRACTICE

"**Gross Sales**" means the aggregate amount, expressed in dollars, of all sales of goods, whether in full or discount prices or for cash or credit, originating from Tenant operated devices within the Premises, provided, however, that the following shall be excluded or deducted (as appropriate) from Gross Sales:

(A) all credit, refunds, and allowances granted to customers until used to purchase goods otherwise included in Gross Sales;

(B) exchanges of merchandise between Tenant's warehouse or other stores and other similar movements of merchandise excepting only deliveries from the store of goods otherwise included in Gross Sales;

(C) returns, including exchanges;

(D) the proceeds from traditional vending machines and commissions on such proceeds;

(E) delivery charges except for product fulfilled from Premises but not sold from Premises;

(F) internet or catalog sales except if fulfilled from Premises.

Reporting Requirements. Landlord's lease forms generally contain reporting requirements that are far more comprehensive than Tenant's requirements.

LANDLORD FORM LANGUAGE

A) Within twenty (20) days after the end of

DRAFTING NOTES

If the definition of Gross Sales accounts for Omnichannel, monthly reporting may be onerous.

each calendar month, Tenant shall submit to Landlord a statement signed by an agent of Tenant stating the Gross Sales for such month. Within sixty (60) days after the end of each Lease Year, Tenant shall furnish Landlord with a statement of Gross Sales attained by Tenant during the preceding Lease Year, certified by Tenant, which statement shall be accompanied by a check for payment of percentage rent, if any, due.

Even 60 days may be too short and Lease Years or even calendar years may not make sense if the company is re-evaluating stores on a different basis.

B) Tenant shall utilize, or cause to be utilized, an accounting system (or systems) in accordance with good retail practice, which will accurately record all Gross Sales. For at least twenty-four (24) months after the expiration of each Lease Year (including any partial Lease Year at the beginning of the Term), Tenant shall keep and maintain (and shall cause all subtenants, concessionaires and licensees to keep and maintain) in the Demised Premises or the main office of Tenant records conforming to such accounting system showing all Gross Sales for such Lease Year.

The more complex the standards of Gross Sales, the more difficult these requirements become to satisfy. These requirements are there to permit simplified Landlord auditing. As we layer Omnichannel into Gross Sales, auditing becomes an onerous challenge.

Operation Of Business Landlord's desire to regulate Tenant's operations has always been a point of contention. Omnichannel exacerbates the issue because it expands the potential methods of store operations.

TRADITIONAL RETAIL LEASE CLAUSE

Except as otherwise set forth herein, Tenant shall (a) fully stock and adequately staff the Demised Premises, and shall continuously and uninterruptedly use, occupy, operate and conduct Tenant's business in the Demised Premises (which business may include areas of the Demised Premises for storage and office purposes, as is reasonably deemed necessary for Tenant's business therein and not for any other business or store); (b) use for office, clerical, storage or other non-selling purposes only such space as is reasonably required for the proper operation of Tenant's business in the Demised Premises, (c) include the address, phone number and name of Center in its advertising.

Tenant shall not (i) permit the use of any portion of the Premises for solicitations, demonstrations or the like.

OMNICHANNEL FRIENDLY LEASE CLAUSE

Except as otherwise set forth herein, Tenant shall adequately stock and staff the Demised Premises, to maximize Gross Sales from the Premises, but shall not be obligated to continuously use, occupy, operate and conduct Tenant's business in the Demised Premises (which business may include areas of the Demised Premises for storage and office purposes). Tenant shall further not be obligated to (a) link the Tenant's website to the Center's website; (b) cause its computer and mobile internet access devices (and any future technological replacements or evolutions) located within the Premises to track all sales made therefrom; and/or (c) include the address, phone number and name of Center on website and mobile platforms as the first option to any search.

Further, Tenant may (i) direct any customers to its website for out of stock product and (ii) operate its website and physical retail store in any way that Tenant deems necessary in order to operate its own business.

Getting Out Of Our Own Way

How landlords, brokers and lawyers can help retailers stay alive.

Nina L. Kampler

Despite the hyperbolic headline-grabbing hysteria ringing the death knell of stores, the retail industry is very much alive. For as long as mankind breathes, we will need supplies. Humans are hardwired to shop. Consumerism, as examined through the periscope of history, is really just an elevated form of our pre-civilization survival skills of hunt-ing and gathering. We collect, we acquire, we devour, we display.

Understanding how we shop today requires reflecting on how we have shopped during other times in history; Only then can we begin to properly envision the shopping of tomorrow. In this context, it becomes clear that mankind will forever shop – shop until we drop, in this literal sense of the word. Rather than contributing to the free fall of retail and helping perpetuate those misconceptions, perhaps we should pause and examine the evolution of retail to help preserve its future viability.

IN THE BEGINNING

Contrary to what an alien landing on our planet today might think, shopping centers are not part of the earth's crust. They grew over time. Historically, retail was limited to a set physical location. Ever been to Pompeii? Or the archeological Roman bazaar ruins in Jerusalem? There you see gathering and bartering places where our ancestors exchanged stories and goods. We left our homes – be they caves or rudimentary huts at the time – to meet up with others: to find love, source food, gain knowledge, and trade goods. For thousands of years, long before the modern mall was manufactured or credit cards invented, and eons before currency was systematized or transportation efficiencies made the entire world accessible, we walked and rode camels and found what we needed and exchanged what we had for what we desired. And all of our transactions occurred at a specific physical place.

Out-of-store retail was first introduced with catalog sales in the late 1800s when Sears, Roebuck and Company issued its inaugural catalog. And for the next 100 years, retail was transacted either at a specific store or through a catalog sale, with an order placed by mail, or later by telephone. In the early 1990s, with the advent of safe encryption of credit card numbers, early experimental online sales began to take root. The launch of Amazon.com in 1994 completed the stage for the dramatic revolution that has drastically changed – and continues to change – the way we shop today. And shopping went from being place-driven to space-driven: We can now shop anywhere and everywhere.

E-COMMERCE, NOW AND THEN

As e-commerce took on life, the retail real estate, legal and brokerage communities were initially concerned with how this would impact existing business models. With rent valuations traditionally based on sales origination, and calculation of gross sales and percentage rents to landlords, how would online sales change this structure? Early confusion quickly quieted down: The volume of online transactions was not enough to be transformative. E-commerce was somewhat limited to books and music, and other tangible goods, that were easily acquired at a desktop computer. The traditional shopping patterns stuck, with online just another venue to purchase certain categories of goods.

Until those patterns didn't stick anymore. The confluence of a drastic recession, and a rising young, technologically savvy demographic all combined to significantly modify shopping behavior.

First, the creation of the iPhone in 2007 was the catalyst for rapidly advancing mobile technology,and it quickly opened channels for smarter, faster, targeted, and interactive e-tail.

Then, the global economic meltdown resulted in the shuttering of thousands of stores, and the re-shaped environment became populated by stronger retailers who used the recession to curate their brands.

Nina Kampler
Kampler Advisory Group

Thirdly, the emergence of the millennial class (roughly defined then 18 to 35-year-olds) translated to a preference for digital shopping for the instant-gratification generation. The smartphone also aided them with comparing pricing instantly during struggling economic times. Constituting approximately 25 percent of the U.S. population, this powerful segment has demonstrated that we can shop with our fingers rather than our feet.

Clearly, same store sales — the traditional barometer by which Wall Street measures retailers' successes — continue to experience muted growth across all channels. Even luxury players, who were responsible for much of the success of urban retail during the period from 2010 through 2015, have been experiencing setbacks during the past few years. Their struggles have been the result of international exchange rates favoring the U.S. dollar, stratospheric real estate valuations in New York City and other high-street gateway marketplaces, and more cautious spending behavior among consumers of all classes.

As online shopping grows, both the size and the sheer number of retail real estate brick-and-mortar establishments will continue to contract. The retailer positioned to survive and thrive is one who embraces the new omni-channel universe.

(continued)

THE HUMAN TOUCH OF IN-STORE

For some retailers, the best use of brick-and-mortar space is as a showroom: a space to see, touch, and try products and services. The store may also be a space to return goods ordered on an iPad on the couch and delivered by FedEx that the consumer can't bear to rebox. It can give the retailer the old fashioned chance to capture the customer's fancy and transact a serendipitous sale. Savvy retailers know that no merchandise, no matter how spectacularly displayed, can be truly Amazon-proofed. Yet, certain classifications require a store setting — a computer can never hand you a glass of wine — and our technology does not yet allow a prospective purchaser to feel the soft fibers of cashmere through a screen. What has emerged is the world of omni-channel, where the silos of bricks and clicks sit not side by side, but integrated as an organic whole.

The interplay between internet and storefront sales, when properly crafted, creates a synergy that results in a sum greater than its separate parts. A synthesized understanding of the offline and online customer delivers a seamless layered multi-channel experience that reinforces loyalty and motivates the consumer to shop. Great brands have figured this out and are working very hard to produce an accessible and compelling shopping experience that anticipates our needs and whims as a consuming public. An excellent merchant must do much more than curate goods to display; he or she must now also deliver them into the palms of our hands wherever we may be.

Retail is not dead, it has been reshuffled and reorganized. So, why the meltdown of stores and proliferation of "for rent" signs? Because the landlords and lawyers and dealmakers are not keeping up with the changes.

VACANCY THREATENS YOUNG BRANDS

Brands collapsing because consumers' tastes are changing is hardly new; it is how the world evolves. But today, the owners, investors and managers of the next generation of retail tenants are no longer willing to be handcuffed to leases with unsustainable economics. The rent barrier to entry in many markets is insurmountable. Retailers are opting to stay local instead of growing their brand or they are limiting themselves to e-commerce instead of following the Warby Parker or Bonobos omni-channel models simply because the rent numbers threaten to kill their start-ups. One international brand, with thousands of stores across the globe, has just shelved its planned rollout in the U.S., un-nerved by the failures and resulting store-front vacancies. The solution to the problem thus disappears in this vicious cycle: the potential future occupants can't make these numbers work either. Retail real estate values have gone down: the store is no longer the entire source of sales, so its value has been diminished. Amazon is not erasing traditional retail, suffocating lease economics is the true culprit.

The families and corporations who control our nation's retail space need to work with their partners, bankers and investors to reshape the rents that are poisoning our retail future. Fifty cents on the dollar might sound low today, but it is fifty cents more than zero. Landlords are holding the golden goose in their hands: fantastic properties across our country, on small main streets and dazzling high streets, in lifestyle centers and luxury malls, in enclosed and open spaces around the country, but they are perched to kill the goose eggs because they want more gold than they can access. Landlords need to confront and accept this new reality. Economics 101 instructs that, at some point, the intersection of supply and demand is met and then the right number of loaves are baked and all people have bread to buy. What is happening in the retail real estate universe today is that the supply line hovers in the stratosphere, danger-ously far from the demand line, and the retailers' engines can't reach there safely. Many landlords are literally living in outer space: outside of the realm of possibility where the deals can be made and kept.

MEETING IN THE MIDDLE

The lawyers can help, too: We need bipartisan attorneys to bridge the gap between landlords' expectations and tenants' needs. How many panels can we listen to where each side sticks to its script that the other side no longer hears? This playbook needs to be tossed out with the large metal cash registers and non-recyclable bags. Why should a landlord, no matter how wonderful the real estate location that is being offered, be entitled to collect a percentage of the sales that are transacted on your phone, in your home, in a café or anywhere because it happens to be in the same zip code as a particular bricks-and-mortar location?

Rent should not be a complicated algorithm. Office rent is calculated by the value of what that parcel is worth, regardless of who shows up at work or what is accomplished in that space. Retailers should be entitled to do the same. Why should the corporate decisions differ for Unilever or Uniqlo? Shouldn't a business decide where to have physical stores in the same way it decides where to lease its regional and local offices — in a way that maximizes overall revenue and creates value for the brand by building its customer base and maximizing sales? It should not matter if the strollers walking into a particular door are there to browse or return or buy anew; if the pulse of the store is alive, it will generate heat. And if it does not, store management won't keep it in its portfolio. Why abort its potential for arbitrary rent reasons that once made sense but should no longer apply?

Retail CFOs and general counsels are distracted trying to resolve when a sale is recognized, where the revenue is recorded, determining the best return policies and procedures and deciding who gets credit for the sale. Why are these even issues? Whether bricks-and-mortar is a store or a showroom should be irrelevant when four-wall profits are no longer the indicator of success, and percentage rent calculations are rendered moot with new business modeling. Lawyers must also be refining the relevancy of operating requirements, radius clauses and other provisions. Our lease documents must address this new reality.

If the landlord and retailer communities come together in their understanding, there is much to be gained. Today's shopping center should not be showcased in a museum tomorrow. We should keep it relevant and viable. We can do this. We just need to keep the golden goose alive. **SCB**

Nina Kampler is founder of Kampler Advisory Group, providing strategic advisory services to retailers and landlords in the U.S. and abroad. She can be reached at nina@kampleradvisorygroup.com

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Topic V

Representing the Not-For-Profit Entity in Leasing

By

Andrew Herz, Esq.
and
Hope Plasha, Esq.

REPRESENTING NOT-FOR-PROFIT TENANTS IN LEASING TRANSACTIONS

Andrew L. Herz
Hope K. Plasha
Patterson Belknap Webb & Tyler LLP

October 10, 2018

I. The Client

A. How are not-for-profit clients different?

1. Real estate is not their core business.

2. Generally, they lack real estate expertise.

3. May be eternal optimists and naïve as to costs.

4. Are subject to greater regulatory and community scrutiny.

5. Board members may hold differing opinions regarding the merits of a project.

B. How is the leasing process different?

1. Often they underestimate the time required from the start-up of their space search to move-in and do not plan for the possibility of construction delays.

2. Often they underestimate the amount of staff personnel involvement required.

3. Frequently they do not realize the disruption to their organization.

4. They may underestimate the cost to their organization – especially with regard to tenant buildout and IT.

5. Need to build in time for, and process to obtain, consent of Board.

6. May think use of a board-connected broker or attorney is an easier path.

C. How are their needs different?

1. May need governmental approvals – medical, education.

2. May be dependent on irregular governmental and foundation support (and such support may be conditioned in various ways, including real property requirements).

3. Accounting for leases (especially after 2020) may be different.

4. May require that physical changes be made to space to comply with law – Article 28, HIPPA.

5. Exemption from real estate taxes if owner is exempt.

6. Potential exemption from sales tax on construction they undertake for their own benefit.

7. May need separate entrance if have client visitations and/or separate elevators and path of travel (particularly for children).

8. May be attractive as a user of designated "community facility space."

9. Need to be attentive to political and community support for major projects given stakeholder relationships.

II. Customary Lease Provisions Which May Affect Not-for-Profits Differently.

1. Permitted use – may define too narrowly – need for flexibility.

2. Cancellation rights – especially if dependent upon government funding or grants.

3. Assignment and subletting – need for transfers to successors and affiliates – stock ownership can't be the test. Net worth tests also do not work.

4. Need to expand and shrink space.

5. Space-sharing with coordinated organizations.

6. Management of costs of buildout and tenant improvement allowances – including landlord fees and holdover expenses at existing space.

7. Costs of services – especially overtime usage.

8. Security deposit – need for flexibility – need for burndown – letter of credit.

9. Renewal rights – especially if large buildout cost.

10. Parking – especially handicapped.

11. Programmatic Requirements (*e.g.*, playgrounds for schools, laboratory and clinical spaces for medical providers).

12. Wish list –

a. green building requirements

b. air quality standards

c. bicycle parking

d. terraces

13. Signage needs.

III. Leasehold Condo

1. New York City has taken position that if have 30+ year leasehold, tenant can create leasehold condominium and be exempt from real estate taxes.

2. Need landlord buy-in.

3. Cost and timing.

REPRESENTING NOT-FOR-PROFIT TENANTS IN LEASING TRANSACTIONS

Andrew L. Herz
Hope K. Plasha
Patterson Belknap Webb & Tyler LLP

October 10, 2018

I. The Client

A. How are not-for-profit clients different?

1. Real estate is not their core business.

2. Generally, they lack real estate expertise.

3. May be eternal optimists and naïve as to costs.

4. Are subject to greater regulatory and community scrutiny.

5. Board members may hold differing opinions regarding the merits of a project.

B. How is the leasing process different?

1. Often they underestimate the time required from the start-up of their space search to move-in and do not plan for the possibility of construction delays.

2. Often they underestimate the amount of staff personnel involvement required.

3. Frequently they do not realize the disruption to their organization.

4. They may underestimate the cost to their organization – especially with regard to tenant buildout and IT.

5. Need to build in time for, and process to obtain, consent of Board.

6. May think use of a board-connected broker or attorney is an easier path.

C. How are their needs different?

1. May need governmental approvals – medical, education.

2. May be dependent on irregular governmental and foundation support (and such support may be conditioned in various ways, including real property requirements).

3. Accounting for leases (especially after 2020) may be different.

4. May require that physical changes be made to space to comply with law – Article 28, HIPPA.

5. Exemption from real estate taxes if owner is exempt.

6. Potential exemption from sales tax on construction they undertake for their own benefit.

7. May need separate entrance if have client visitations and/or separate elevators and path of travel (particularly for children).

8. May be attractive as a user of designated "community facility space."

9. Need to be attentive to political and community support for major projects given stakeholder relationships.

II. <u>Customary Lease Provisions Which May Affect Not-for-Profits Differently.</u>

1. Permitted use – may define too narrowly – need for flexibility.

2. Cancellation rights – especially if dependent upon government funding or grants.

3. Assignment and subletting – need for transfers to successors and affiliates – stock ownership can't be the test. Net worth tests also do not work.

4. Need to expand and shrink space.

5. Space-sharing with coordinated organizations.

6. Management of costs of buildout and tenant improvement allowances – including landlord fees and holdover expenses at existing space.

7. Costs of services – especially overtime usage.

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III. Leasehold Condo

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2. Need landlord buy-in.

3. Cost and timing.

Topic V

Leasing Issues for Tax Exempt Entities

By

Sunjata Yalamanchili, Esq.

Leasing Issues for Tax Exempt Entities

Under the NY Not-for-Profit Corporations Law (N-PCL), an entity may qualify as either a charitable or non-charitable not-for-profit corporation if the ordinary purpose of the corporation is not for pecuniary profit or financial gain. (NY Not-for-Profit Corp. L. § 102 (McKinney)). An entity may qualify as a religious corporation under the NY Religious Corporations Law if created primarily for religious purposes. (NY Relig. Corp. L. § 2 (McKinney)). If a registered not-for-profit corporation or a religious corporation seeks to enter a real property lease as a landlord, the corporation must abide by a particular set of requirements.

The NY Not-for-Profit Corporations Law and NY Religious Corporations Law govern these situations. A good starting point considers whether the entity is registered as a not-for-profit corporation or a religious corporation, as some requirements differ between each entity. The requirements also differ depending on whether the entity is leasing out property it owns (acting as a landlord), or looking to lease property for its own use (acting as lessee).

A. Not-for-Profit Corporation

Authorization

Section 509(b) of the Not-for-Profit Corporations Law states that "[n]o corporation shall sell, mortgage, lease, exchange or otherwise dispose of its real property unless authorized by the vote of a majority of directors of the board or of a majority of a committee authorized by the board . . . ." So, in order to lease property to a tenant, a not-for-profit entity must obtain authorization for the transaction from its board of directors. For an isolated transaction involving real property, the entity must obtain authorization by "the vote of a majority of directors of the board or of a majority of a committee authorized by the board." (§ 509(b)). However, if the transaction involves "*all, or substantially all*, of the assets of the corporation," the entity must obtain authorization by two-thirds of the entire board or, if there are twenty-one or more members, authorization by the vote of a majority. (§ 509(b) (emphasis added)). Each entity's bylaws may provide further voting requirements. If the not-for-profit is leasing property for its own benefit, board approval is not required, although it may be obtained as a precaution.

For a transaction involving all or substantially all of a non-charitable corporation's assets, the board must adopt a resolution specifying "terms and conditions of the proposed transaction, including the consideration to be received by the corporation and the eventual disposition to be made of such consideration, together with a statement that the dissolution of the corporation is or is not contemplated thereafter." (§ 510(a)(1)). If the board passes the resolution, the corporation's members (if any) must subsequently approve it. The members may approve the transaction as specified in the board's resolution, or the members may approve the transaction while authorizing the board to modify the terms and conditions of the transaction. (§ 510(a)(1)).

Approval

On the other hand, a charitable corporation (a Type B, Type C, or Type D with charitable purposes), must not only obtain board and member approval for a sale or lease of real property

constituting all or substantially all of its assets, but "shall **in addition require approval of the attorney general or the supreme court** in the judicial district or of the county court of the county in which the corporation has its office or principal place of carrying out the purposes for which it was formed . . . ." (§ 510(a)(3)).

To obtain Attorney General (AG) review under N-PCL § 511-a:

1. Corporation submits a draft petition to the AG before submission to the court, allowing the AG to perform a preliminary compliance review (note, this is not available to insolvent corporations)
2. The AG may require additional information while reviewing the petition
3. The AG can approve the transaction by writing "Attorney General's Approval" on the petition

Note – this method is preferred by the Charities Bureau.

To obtain Court approval, with notice to the AG under N-PCL § 511:

1. Corporation files a verified petition with the court
2. Corporation must give AG at least 15 days' notice before a hearing on the petition
3. The AG will grant a "no objection" endorsement on the petition if it complies with all requirements, or the AG may require the corporation to give notice to interested parties and have a hearing before the court

Both the court and the AG apply the same standard of review when evaluating a not-for-profit corporation's proposed transaction. The court and AG consider two prongs:

1. Whether the terms of the transaction are fair and reasonable to the corporation, and
    a. Valuation: while not explicitly required by the Not-for-Profit law, case law suggests that an independent appraiser should value the property using at least three comparable sales.
    b. Conflicts of Interest: the court and AG consider whether an officer, director, member, employee, or other party has an interest in the transaction
2. Whether the transaction serves the purpose of the corporation or its members.
    a. Proceeds: any proceeds obtained from the transaction must be distributed or allocated according to the corporation's charitable purpose; they cannot be used to benefit a particular director, officer, member, etc.

Transactions involving interested parties, such as directors, officers, or members, must comply with additional requirements as stated in N-PCL § 715.

B. Religious Corporations

Authorization

Like not-for-profit corporations, the board and members of religious corporations must authorize the transaction. However, a particular religious sect may have specific quorum requirements stated in the Religious Corporations Law (for example, RCL § 134 lists requirements for corporate meetings held by Baptist Churches).

Approval

Section 12 NY Religious Corporation Law provides that "a religious corporation shall not sell, mortgage or lease for a term exceeding five years any of its real property without applying for and obtaining leave of the court or the attorney general therefore . . ." pursuant to the requirements in N-PCL § 511 and § 511-a. A specific list of churches are only required to seek court approval, and need not notify the AG. Unlike for not-for-profit corporations, court or AG approval is required *even if* the property does not constitute all or substantially all of the religious corporation's assets. Purchase money mortgages and purchase money security agreements do not require court or AG approval.

The court and AG apply the same two-prong test to both religious corporations and not-for-profit corporations: whether the transaction is fair and reasonable and whether it serves the purpose of the religious corporation or its members. (N-PCL §§ 511(d), 511-a(c)). While most religious entities should obtain an appraisal to demonstrate the fairness of the transaction, a solvent religious corporation seeking to convey property to "another religious corporation, or to a membership, educational, municipal or other non-profit corporation" need not obtain an appraisal if the transaction is for nominal consideration. (RCL § 12(8)).

C. Other Considerations

Attorneys should be aware that several issues may arise when a not-for-profit or religious corporation engages in a real property transaction. These issues include:

1. Tax implications – such as private benefit and private inurement rules; may also incur penalties under the IRS and New York State
2. Conflicts of interest – such as when a board member or director has a financial stake in the transaction
3. Particularized requirements for public versus private charities – such as self-dealing and excess benefit transactions
4. Unrelated Taxable Business Income (UBIT)

Summary:

Entity Type	Applicable Law	Board approval required to act as landlord?	Court or AG approval required to act as landlord?	Board approval required enter lease as lessee?
Not-for-Profit Corporation: *non-charitable purpose*	NY N-PCL §§ 509–511-a	Yes	No	No*
Not-for-Profit Corporation: Type B, Type C, or Type D corporation with *charitable purpose*	NY N-PCL §§ 509–511-a	Yes	Yes, if transaction involves "all or substantially all" of corporation's assets	No*
Religious Corporation	NY RCL § 12 NY N-PCL §§ 509–511-a	Yes	Yes, regardless of size of assets* (but – leases for less than a 5-year term do not require approval)	No*

*Bylaws of the individual entities may impose additional requirements.

Implications of Sale Leaseback Transactions

By

Sunjata Yalamanchili, Esq.

Implications of Sale-Leaseback Transactions

Background

A sale-leaseback occurs when one party sells property to a buyer, who then leases the property back to the seller. Although this arrangement occurs in a single transaction, it creates a relationship between the seller/tenant and buyer/landlord that extends beyond the initial sale of the property. Parties should craft sale-leaseback transactions with the tax implications and future relationships in mind.

Tax Implications

A. Benefits of a Sale-Leaseback Transaction

1. Tax Benefits for Seller/Tenant – tenants may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. (26 U.S.C. § 162 (a)(3) (2012)).
2. Tax Benefits for Buyer/Landlord – buyer/landlord can take a depreciation deduction, and if the property is financed, the buyer/landlord may be able to deduct the loan's interest. (26 U.S.C. §§ 163, 167, 168 (2012)).
3. Liquidity – seller/tenant can put cash from the purchase price toward other investments
4. Value & Rate of Return – buyer/landlord can add investment property to its portfolio that generally performs at a predictable, high rate of return
5. Financing – parties have freedom to structure financing and options to purchase or extend

B. Drawbacks of a Sale-Leaseback Transaction

1. Disqualified Transaction – the IRS may interpret the sale-leaseback transaction as an attempt to avoid federal income tax. In such a case, the seller/tenant will have to evaluate taxable income based on the constant rental accrual rate of the property.
2. Like-kind Exchange – parties cannot recognize a gain or loss a transaction involving the exchange of a lease in real estate for 30 years or more for a fee interest in real estate. (26 U.S.C. § 1031(a); 26 C.F.R. 1.103 (2018)).
3. Financing Transaction – the IRS may find that the buyer/landlord is actually making a loan to the seller/tenant, and therefore prohibits the seller/tenant from taking rental deductions, prohibits the buyer/landlord from reporting income in the form of rental payments, and reallocates the depreciation deduction to the seller/tenant. (*See, e.g.*, *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939)).
4. Double Transfer Taxation – parties may be required to pay transfer tax on the sale of property and on the subsequent leasehold interest. (20 N.Y.C.R.R. § 575.7 (2018)).

C. Avoiding Problems with a Sale-Leaseback Transaction: Economic Substance

Depending on how the parties structure the sale-leaseback transaction, the IRS and/or the courts may require the parties to forgo important tax deductions. If so, neither party may receive the benefit of its bargain.

The IRS and the courts typically view sale-leaseback transactions as a whole, rather than simply considering the form of the transaction. Therefore, parties structuring a sale-leaseback transaction should do so carefully to avoid unintended tax consequences. If a transaction is an arms-length transaction, is "not shaped solely by tax-avoidance features that have meaningless labels attached," and the "lessor retains significant and genuine attributes of traditional lessor status," the IRS or court may find that the transaction has sufficient economic substance. (*Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583–84 (1978)). The parties should ensure that the purpose of the transaction extends beyond simply avoiding paying higher income taxes on the property.

Protecting the Parties' Relationship

A. Loss of Flexibility

The seller's relationship with the property changes significantly upon the sale and subsequent lease of the property, as the seller/tenant loses some aspects of control. The buyer/landlord may impose restrictions or covenants on the land that the seller/tenant must follow. Additionally, the parties should consider either party's rights with respect to terminating, assigning, or subletting the lease, and whether the seller/tenant has an option to purchase the property or extend the lease upon expiration of the lease term.

B. Classification of Lease

The seller/tenant and buyer/landlord typically enter into triple net leases, where the seller/tenant pays property taxes, insurance, and maintains the property. As investment property, the buyer/landlord has an interest in the property's upkeep. The parties should agree on the scope of these responsibilities before entering into the lease.

C. Seller/Tenant's Interest

Because an option to purchase as part of the sale-leaseback may trigger unintended tax consequences, the seller/tenant may not have an ownership interest at the end of the lease term. To protect its interest, the seller/tenant should plan in advance whether it plans to purchase the property for fair market value, extend the lease, or relocate to different premises upon expiration of the lease.

D. Buyer/Landlord's Bankruptcy

If the buyer/landlord files for bankruptcy, the seller/tenant may lose any rights it had to extend the lease or purchase the property. The seller/tenant may have some protections under bankruptcy law.

Conclusion

Parties considering a sale-leaseback transaction should carefully evaluate the transaction's benefits and drawbacks. A transaction structured with economic substance and evidence of some purpose beyond simply avoiding federal income taxation lowers each party's risk. Furthermore, negotiating the scope of the seller/tenant and buyer/landlord relationship before entering into the transaction reduces the likelihood of complications between the parties in the future.

Topic VI

Letters of Credit and Guarantees
And
Case Law

Materials Submitted By Michael Reyan

[BANK NAME]

IRREVOCABLE STANDBY LETTER OF CREDIT

LETTER OF CREDIT NO.: (LC NUMBER INSERTED)

DATE: (INSERTED AT TIME OF ISSUANCE), 20__

ISSUING BANK:

ADDRESS:

EXPIRATION DATE:

AMOUNT:

BENEFICIARY:

WE HEREBY ESTABLISH IN YOUR FAVOR OUR IRREVOCABLE LETTER OF CREDIT NO (1c number inserted) IN THE AMOUNT OF _____ FOR THE ACCOUNT OF _____.

DEMANDS FOR PAYMENT UP TO THE MAXIMUM AGGREGATE AMOUNT AVAILABLE UNDER THIS LETTER OF CREDIT SHALL BE PAID BY US AT OR BEFORE 1:00 P.M. PACIFIC TIME ON THE NEXT SUCCEEDING BUSINESS DAY AFTER OUR RECEIPT ON OR PRIOR TO OUR CLOSE OF BUSINESS ON THE EXPIRATION DATE, OF ONE OR MORE DRAFTS IN THE FORM OF ANNEX A HERETO SIGNED BY YOUR AUTHORIZED OFFICER OR REPRESENTATIVE OR, IF THIS LETTER OF CREDIT IS TRANSFERRED, BY AN AUTHORIZED OFFICER OR REPRESENTATIVE OF ANY TRANSFEREE BENEFICIARY. EACH DRAFT DRAWN HEREON SHALL BE ADDRESSED TO US, REFERENCE THIS LETTER OF CREDIT BY NUMBER, SPECIFY THE AMOUNT OF SUCH DRAFT AND OTHERWISE BE IN THE FORM OF ANNEX A HERETO, AND BE PRESENTED TOGETHER WITH THE ORIGINAL LETTER OF CREDIT AND ANY AMENDMENTS, AND BENEFICIARY'S SIGNED STATEMENT BY AN AUTHORIZED REPRESENTATIVE OF BENEFICIARY STATING AS FOLLOWS:

“THE UNDERSIGNED HEREBY CERTIFIES THAT BENEFICIARY IS ENTITLED TO DRAW ON THE LETTER OF CREDIT PURSUANT TO THAT CERTAIN OFFICE LEASE DATED _____ BY AND BETWEEN _____ AND _____, AS IT MAY BE AMENDED OR ASSIGNED FROM TIME TO TIME."

OR

"THE UNDERSIGNED HEREBY CERTIFIES THAT BENEFICIARY HAS RECEIVED A WRITTEN NOTICE OF BANK'S ELECTION NOT TO EXTEND ITS STANDBY LETTER OF CREDIT NO. _____ AND BENEFICIARY HAS NOT RECEIVED A REPLACEMENT LETTER OF CREDIT WITHIN FORTY FIVE (45) DAYS PRIOR TO THE PRESENT EXPIRATION DATE."

THE LEASE AGREEMENT MENTIONED ABOVE IS FOR IDENTIFICATION PURPOSES ONLY AND IT IS NOT INTENDED THAT SAID LEASE AGREEMENT BE INCORPORATED HEREIN OR FORM PART OF THIS LETTER OF CREDIT.

MULTIPLE DRAWS ARE EXPRESSLY PERMITTED. PARTIAL DRAWINGS ARE ALLOWED. IF YOUR DEMAND REPRESENTS A PARTIAL DRAW, WE WILL ENDORSE THE ORIGINAL LETTER OF CREDIT OF SUCH PAID PARTIAL DRAW AND RETURN THE ORIGINAL LETTER OF CREDIT TO YOU BY OVERNIGHT COURIER SERVICE FOR ANY FUTURE DRAWS.

AS USED IN THIS LETTER OF CREDIT, "BUSINESS DAY" SHALL MEAN ANY DAY OTHER THAN A SATURDAY, SUNDAY OR A DAY ON WHICH BANKING INSTITUTIONS IN THE STATE OF NEW YORK ARE AUTHORIZED OR REQUIRED BY LAW TO CLOSE.

THIS LETTER OF CREDIT SHALL INITIALLY EXPIRE ON ___, 20__. SUCH EXPIRATION DATE SHALL BE AUTOMATICALLY EXTENDED WITHOUT NOTICE OR AMENDMENT FOR PERIODS OF ONE (1) YEAR, BUT IN NO EVENT LATER THAN _____, 20__, UNLESS AT LEAST FORTY FIVE (45) DAYS BEFORE ANY EXPIRATION DATE, WE NOTIFY YOU BY REGISTERED MAIL OR OVERNIGHT COURIER SERVICE AT YOUR ADDRESS ABOVE, THAT THIS LETTER OF CREDIT WILL NOT BE EXTENDED BEYOND THE THEN-CURRENT EXPIRATION DATE. UPON RECEIPT BY YOU OF SUCH NOTIFICATION, YOU MAY DRAW ON THIS LETTER OF CREDIT AS SET FORTH ABOVE, PROVIDED THAT THE AMOUNT OF YOUR DRAW SHALL NOT EXCEED THE TOTAL AMOUNT THEN AVAILABLE FOR PAYMENT HEREUNDER.

DRAW REQUESTS MAY BE SUBMITTED IN PERSON, BY COURIER, OR BY MAIL TO OUR ADDRESS STATED ABOVE.

THIS LETTER OF CREDIT IS TRANSFERABLE ONE OR MORE TIMES IN ITS ENTIRETY UPON OUR RECEIPT OF A TRANSFER REQUEST IN THE FORM ATTACHED AS EXHIBIT B, SIGNED BY THE THEN CURRENT BENEFICIARY. TRANSFER FEES ARE FOR ACCOUNT OF THE APPLICANT.

WE HEREBY ENGAGE WITH YOU THAT ALL SIGHT DRAFTS DRAWN UNDER AND IN COMPLIANCE WITH THE TERMS AND CONDITIONS OF THIS LETTER OF CREDIT SHALL BE DULY HONORED IF PRESENTED FOR PAYMENT AT THE OFFICE OF _____ ON OR BEFORE THE EXPIRATION DATE OF THIS LETTER OF CREDIT.

THIS STANDBY LETTER OF CREDIT IS SUBJECT TO THE UNIFORM CUSTOMS AND PRACTICES FOR DOCUMENTARY CREDITS, 2007 REVISION (ICC PUBLICATION NO. 600 AND ANY SUBSEQUENT REVISION THEREOF) EXCEPT TO THE EXTENT THE SAME WOULD BE INCONSISTENT WITH THE EXPRESS PROVISIONS HEREOF. WE HEREBY WAIVE AND DISCLAIM RIGHTS OF SUBROGATION IN RESPECT OF ANY DRAW MADE BY YOU, WHETHER ARISING UNDER THE UNIFORM COMMERCIAL CODE OR OTHERWISE.

_____
AUTHORIZED OFFICER

_____
AUTHORIZED OFFICER

THIS ANNEX A IS AN INTEGRAL PART OF CITY NATIONAL BANK IRREVOCABLE STANDBY LETTER OF CREDIT NO.

ANNEX A

Form of
SIGHT DRAFT

DATE: _____ REF. NO. _____

AT SIGHT

PAY TO THE ORDER OF _____
US$_____

US DOLLARS

_____

"DRAWN UNDER _____ BANK, IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER NO. _____ DATED _____, 20___"

TO:

(INSERT NAME OF BENEFICIARY)

_____
AUTHORIZED SIGNATURE

NOTE: BENEFICIARY'S NAME SHOULD BE PRINTED AT THE BACK OF THE SIGHT DRAFT WITH ENDORSEMENT.

EXHIBIT 'B'

THIS EXHIBIT B IS AN INTEGRAL PART OF _____ BANK IRREVOCABLE STANDBY LETTER OF CREDIT NO.

TRANSFER INSTRUCTIONS FORM

TO: DATE:

RE: _____ Bank Letter of Credit No. _____, Dated _____

Ladies/Gentlemen:

For value received, the undersigned beneficiary hereby irrevocably transfers to:

(Name of Transferee)
(Address of Transferee)

all rights of the undersigned beneficiary to draw under the above-referenced Letter of Credit in its entirety.

By this transfer, all rights of the undersigned beneficiary in such Letter of Credit are transferred to the transferee and the transferee shall have the sole rights as beneficiary thereof, including sole rights relating to any amendments whether increases or extensions or other amendments and whether now existing or hereafter made. All amendments are to be advised direct to the transferee without necessity of any consent of or notice to the undersigned beneficiary.

The original of the Letter of Credit is returned herewith together with any and all amendments, and we ask you to endorse the transfer on the reverse of the Letter of Credit, and forward it direct to the transferee with your customary notice of transfer.

Beneficiary name:

_____
Authorized Signature:

_____
Name of signer:

_____
Title of signer:

Signature Guaranteed
The beneficiary's signature with title conforms with that on file with us and as such is authorized for the execution of this document.

_____
Name of Bank:

_____
Authorized Signature:

_____
Name of signer:

_____
Title of signer:

_____
Telephone number:

[BANK NAME]

IRREVOCABLE STANDBY LETTER OF CREDIT

LETTER OF CREDIT NO.: (LC NUMBER INSERTED)

DATE: (INSERTED AT TIME OF ISSUANCE), 20__

ISSUING BANK:

ADDRESS:

EXPIRATION DATE:

AMOUNT:

BENEFICIARY:

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DEMANDS FOR PAYMENT UP TO THE MAXIMUM AGGREGATE AMOUNT AVAILABLE UNDER THIS LETTER OF CREDIT SHALL BE PAID BY US AT OR BEFORE 1:00 P.M. PACIFIC TIME ON THE NEXT SUCCEEDING BUSINESS DAY AFTER OUR RECEIPT ON OR PRIOR TO OUR CLOSE OF BUSINESS ON THE EXPIRATION DATE, OF ONE OR MORE DRAFTS IN THE FORM OF ANNEX A HERETO SIGNED BY YOUR AUTHORIZED OFFICER OR REPRESENTATIVE OR, IF THIS LETTER OF CREDIT IS TRANSFERRED, BY AN AUTHORIZED OFFICER OR REPRESENTATIVE OF ANY TRANSFEREE BENEFICIARY. EACH DRAFT DRAWN HEREON SHALL BE ADDRESSED TO US, REFERENCE THIS LETTER OF CREDIT BY NUMBER, SPECIFY THE AMOUNT OF SUCH DRAFT AND OTHERWISE BE IN THE FORM OF ANNEX A HERETO, AND BE PRESENTED TOGETHER WITH THE ORIGINAL LETTER OF CREDIT AND ANY AMENDMENTS, AND BENEFICIARY'S SIGNED STATEMENT BY AN AUTHORIZED REPRESENTATIVE OF BENEFICIARY STATING AS FOLLOWS:

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OR

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ABOVE WORDING APPROVED FOR ISSUANCE OF STANDBY LETTER OF CREDIT
_____ AUTHORIZED SIGNATURE, _____

AS USED IN THIS LETTER OF CREDIT, "BUSINESS DAY" SHALL MEAN ANY DAY OTHER THAN A SATURDAY, SUNDAY OR A DAY ON WHICH BANKING INSTITUTIONS IN THE STATE OF NEW YORK ARE AUTHORIZED OR REQUIRED BY LAW TO CLOSE.

THIS LETTER OF CREDIT SHALL INITIALLY EXPIRE ON ___, 20__. SUCH EXPIRATION DATE SHALL BE AUTOMATICALLY EXTENDED WITHOUT NOTICE OR AMENDMENT FOR PERIODS OF ONE (1) YEAR, BUT IN NO EVENT LATER THAN _____, 20__, UNLESS AT LEAST FORTY FIVE (45) DAYS BEFORE ANY EXPIRATION DATE, WE NOTIFY YOU BY REGISTERED MAIL OR OVERNIGHT COURIER SERVICE AT YOUR ADDRESS ABOVE, THAT THIS LETTER OF CREDIT WILL NOT BE EXTENDED BEYOND THE THEN-CURRENT EXPIRATION DATE. UPON RECEIPT BY YOU OF SUCH NOTIFICATION, YOU MAY DRAW ON THIS LETTER OF CREDIT AS SET FORTH ABOVE, PROVIDED THAT THE AMOUNT OF YOUR DRAW SHALL NOT EXCEED THE TOTAL AMOUNT THEN AVAILABLE FOR PAYMENT HEREUNDER.

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WE HEREBY ENGAGE WITH YOU THAT ALL SIGHT DRAFTS DRAWN UNDER AND IN COMPLIANCE WITH THE TERMS AND CONDITIONS OF THIS LETTER OF CREDIT SHALL BE DULY HONORED IF PRESENTED FOR PAYMENT AT THE OFFICE OF _____ ON OR BEFORE THE EXPIRATION DATE OF THIS LETTER OF CREDIT.

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_____
AUTHORIZED OFFICER

_____
AUTHORIZED OFFICER

ABOVE WORDING APPROVED FOR ISSUANCE OF STANDBY LETTER OF CREDIT
_____ AUTHORIZED SIGNATURE, _____

THIS ANNEX A IS AN INTEGRAL PART OF CITY NATIONAL BANK IRREVOCABLE STANDBY LETTER OF CREDIT NO.

ANNEX A

Form of
SIGHT DRAFT

DATE: _____ REF. NO. _____

AT SIGHT

PAY TO THE ORDER OF _____
US$_____

US DOLLARS

_____

"DRAWN UNDER _____ BANK, IRREVOCABLE STANDBY LETTER OF CREDIT NUMBER NO. _____ DATED _____, 20___"

TO:

(INSERT NAME OF BENEFICIARY)

_____
AUTHORIZED SIGNATURE

NOTE: BENEFICIARY'S NAME SHOULD BE PRINTED AT THE BACK OF THE SIGHT DRAFT WITH ENDORSEMENT.

ABOVE WORDING APPROVED FOR ISSUANCE OF STANDBY LETTER OF CREDIT
_____ AUTHORIZED SIGNATURE, _____

EXHIBIT 'B'

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TRANSFER INSTRUCTIONS FORM

TO: DATE:

RE: _____ Bank Letter of Credit No. _____, Dated _____

Ladies/Gentlemen:

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(Name of Transferee)
(Address of Transferee)

all rights of the undersigned beneficiary to draw under the above-referenced Letter of Credit in its entirety.

By this transfer, all rights of the undersigned beneficiary in such Letter of Credit are transferred to the transferee and the transferee shall have the sole rights as beneficiary thereof, including sole rights relating to any amendments whether increases or extensions or other amendments and whether now existing or hereafter made. All amendments are to be advised direct to the transferee without necessity of any consent of or notice to the undersigned beneficiary.

The original of the Letter of Credit is returned herewith together with any and all amendments, and we ask you to endorse the transfer on the reverse of the Letter of Credit, and forward it direct to the transferee with your customary notice of transfer.

Beneficiary name:

_____
Authorized Signature:

_____
Name of signer:

_____
Title of signer:

Signature Guaranteed
The beneficiary's signature with title conforms with that on file with us and as such is authorized for the execution of this document.

_____
Name of Bank:

_____
Authorized Signature:

_____
Name of signer:

_____
Title of signer:

_____
Telephone number:

ABOVE WORDING APPROVED FOR ISSUANCE OF STANDBY LETTER OF CREDIT
_____ AUTHORIZED SIGNATURE, _____

41 B.R. 398
United States Bankruptcy Court,
S.D. New York.

In re ELEGANT MERCHANDISING, INC.,
Debtor.
ELEGANT MERCHANDISING, INC., Plaintiff,
v.
REPUBLIC NATIONAL BANK and Bank Leumi
Trust Company of New York, Defendants.

Bankruptcy No. 84 B 10903 (HCB).
|
Adv. No. 84 6014A.
|
Aug. 30, 1984.

Synopsis
By order to show cause and application, debtor sought to enjoin one bank from demanding payment or performance from other bank under other bank's letter of credit and to enjoin other bank from honoring demands for payments or performance under letter of credit. The Bankruptcy Court, Edward J. Ryan, J., held that: (1) there was no proper legal authority under which either bank could be enjoined from exercising their respective rights and obligations under letter of credit, and (2) first bank was not entitled to attorney fees.

Application denied.

West Headnotes (4)

[1] **Finance, Banking, and Credit**
Letters of credit

There was no proper legal authority under which one bank could be enjoined from demanding payment or performance from other bank under its letter of credit or other bank could be enjoined from honoring demands for payments or performance under letter of credit.

1 Cases that cite this headnote

[2] **Bankruptcy**
Proceedings, Acts, or Persons Affected
Bankruptcy
Letters of credit

Letter of credit and its proceeds are not "property of the estate," and therefore, payment of letter of credit is not transfer of assets in violation of automatic stay. Bankr.Code, 11 U.S.C.A. §§ 362, 541.

6 Cases that cite this headnote

[3] **Finance, Banking, and Credit**
Letters of Credit

Letter of credit and its proceeds constitute property of bank.

4 Cases that cite this headnote

[4] **Bankruptcy**
Frivolity or bad faith; sanctions

Debtor's application to enjoin one bank from demanding payment or performance from other bank under other bank's letter of credit and to enjoin other bank from honoring demands for payments or performance under letter of credit was filed in good faith, and therefore first bank was not entitled to attorney fees. Fed.Rules Civ.Proc.Rule 11, 28 U.S.C.A.

2 Cases that cite this headnote

Attorneys and Law Firms

***399** Lester A. Lazarus, P.C., New York City, for debtor-plaintiff.

Kreindler & Relkin, P.C., New York City, for defendant

Republic National Bank.

Hahn & Hessen, New York City, for Bank of Leumi Trust Company of New York.

Opinion

EDWARD J. RYAN, Bankruptcy Judge.

On June 8, 1984, Elegant Merchandising, Inc. filed a voluntary petition under Chapter 11 of the Bankruptcy Code (Code). 11 U.S.C. 1101 *et seq.*

On July 24, 1984, by order to show cause and application, the debtor sought to enjoin Republic National Bank of New York (Republic) from demanding payment or performance from Bank Leumi Trust Company of New York (Bank Leumi) under Bank Leumi's Letter of Credit # 8795 and to enjoin Bank Leumi from honoring demands for payments or performance under the letter of credit.

The debtor's application was heard on July 26, 1984.

[1] The debtor's application is denied. The court finds that there is no proper legal authority under which Republic or Bank of Leumi can be enjoined from exercising their respective rights and obligations under the letter of credit.

[2] [3] A letter of credit and its proceeds are not "property of the estate" within the meaning of 11 U.S.C. 541, and therefore the payment of a letter of credit is not a transfer of assets in violation of the automatic stay provisions of 11 U.S.C. 362. The letter of credit and its proceeds constitute property of the bank. *In re Page*, 18 B.R. 713, 714–16 (D.D.C.1982).

[4] Republic National Bank made an oral application at the hearing for attorneys fees under Federal Rule 11 on the ground that the debtor's application was patently frivolous. The court finds that the debtor's application was filed in good faith and therefore the application for expenses should be denied.

It is so ordered.

All Citations

41 B.R. 398

430 F.3d 260
United States Court of Appeals,
Fifth Circuit.

In re STONEBRIDGE TECHNOLOGIES, INC., Debtor.
EOP–Colonnade of Dallas Limited Partnership, Appellant,
v.
Dennis Faulkner, In his capacity as Trustee of the SBTI Liquidating Trust, Appellee.

No. 04–10494.
|
Nov. 8, 2005.

Synopsis
Background: Trustee of liquidating trust established under debtor-lessee's confirmed Chapter 11 plan brought cause of action against debtor's lessor to recover for lessor's alleged breach of contract and negligent misrepresentations in drawing on letter of credit issued to secure debtor's performance under lease. The United States Bankruptcy Court for the Northern District of Texas entered judgment in favor of trustee, and lessor appealed. The District Court, Jorge A. Solis, J., affirmed.

Holdings: On further appeal, the Court of Appeals held that:

[1] trustee's claims were within "core" jurisdiction of bankruptcy court;

[2] cap on lessor's damages claim for Chapter 11 debtor-lessee's breach of rejected lease applied only to any claim lessor filed for payment of this damages claim from property of the estate, and did not limit amount that lessor could recover under letter of credit issued to secure debtor's performance under lease;

[3] motion that commercial lessor filed in debtor-lessee's Chapter 11 case to compel payment of past due rent qualified as adequate notice under lease of debtor-lessee's monetary default, of kind required to permit commercial lessor to draw on letter of credit; and

[4] bankruptcy court order providing for rejection of debtor's lease *nunc pro tunc* order cured any prematurity in lessor's draw request.

Reversed and remanded.

West Headnotes (17)

[1] **Bankruptcy**
Conclusions of law; de novo review
Bankruptcy
Clear error

On appeal from district court's decision in its bankruptcy appellate capacity, Court of Appeals applies the same standard of review as district court: Court reviews bankruptcy court's conclusions of law and mixed questions of law and fact *de novo*, and reviews bankruptcy court's findings of fact for clear error. Fed.Rules Bankr.Proc.Rule 8013, 11 U.S.C.A.

21 Cases that cite this headnote

[2] **Bankruptcy**
Court of Appeals

On appeal in bankruptcy case, Court of Appeals was obliged to raise jurisdictional issues *sua sponte*, even though neither party had raised them, where jurisdiction, at least over some of claims raised, appeared questionable.

3 Cases that cite this headnote

[3] **Bankruptcy**
Bankruptcy Jurisdiction

To determine whether particular matter falls within general jurisdiction of bankruptcy court, court asks whether outcome of proceeding could

have any conceivable effect on estate being administered in bankruptcy.

7 Cases that cite this headnote

[4] **Bankruptcy**
Related proceedings

Proceeding is within "related to" jurisdiction of bankruptcy court if its outcome could alter debtor's rights, liabilities, options or freedom of action, either positively or negatively, and it in any way impacts on handling and administration of bankruptcy estate.

7 Cases that cite this headnote

[5] **Bankruptcy**
Construction, execution, and performance

Claims asserted by trustee of liquidating trust established under debtor-lessee's confirmed Chapter 11 plan, for lessor's alleged breach of terms of commercial lease included in "property of the estate," was within bankruptcy court's general bankruptcy jurisdiction; any recovery on claims brought by trustee for breach of lease would go directly to estate for damage done to estate.

1 Cases that cite this headnote

[6] **Bankruptcy**
Construction, execution, and performance

Claims asserted by trustee of liquidating trust established under debtor-lessee's confirmed Chapter 11 plan, in his capacity as assignee of bank that had issued letter of credit to secure debtor's obligations under lease, for lessor's alleged negligent misrepresentations when drawing on letter of credit were within bankruptcy court's general bankruptcy jurisdiction; while assignment alone could not transform claims that bankruptcy court could not have heard to claims within its jurisdiction, any recovery by bank on its negligent misrepresentation claims against lessor would have impacted upon estate by alleviating need for indemnification/reimbursement from debtor.

6 Cases that cite this headnote

[7] **Bankruptcy**
Core or non-core proceedings

Proceeding is within "core" jurisdiction of bankruptcy court if it invokes a substantive right provided by title 11 or if it is proceeding that, by its nature, could arise only in context of bankruptcy case.

8 Cases that cite this headnote

[8] **Bankruptcy**
Construction, execution, and performance

Claims asserted by trustee of liquidating trust established under debtor-lessee's confirmed Chapter 11 plan, for lessor's alleged breach of terms of debtor's commercial lease both by prematurely drawing on letter of credit that secured debtor's leasehold obligations, prior to entry of bankruptcy court order approving debtor's announced intent to reject lease, and by drawing on letter of credit for amount in excess of damages cap established by the Bankruptcy Code, came within "core" jurisdiction of bankruptcy court, where controlling questions that were raised by these breach of contract claims involved interpretation of "lease rejection" and "damages cap" provisions of the Bankruptcy Code. 11 U.S.C.A. §§ 365(a), 502(b)(6).

4 Cases that cite this headnote

[9] **Bankruptcy**

Construction, execution, and performance

Assigned claims, that trustee of liquidating trust was asserting in shoes of bank that had issued letter of credit to secure Chapter 11 debtor's obligations under its commercial lease, for lessor's negligent misrepresentations in prematurely representing that it had right to draw on letter of credit, prior to entry of bankruptcy court order approving debtor's announced intent to reject lease, and in asserting claim against letter of credit for amount in excess of damages cap established by the Bankruptcy Code, came within bankruptcy court's "core" jurisdiction, where controlling questions that were raised by these third-party, negligent misrepresentation claims involved interpretation of "lease rejection" and "damages cap" provisions of the Bankruptcy Code. 11 U.S.C.A. §§ 365(a), 502(b)(6).

5 Cases that cite this headnote

[10] **Bankruptcy**
Rejection of executory contract or lease

Cap on lessor's damages claim for Chapter 11 debtor-lessee's breach of rejected lease applied only to any claim lessor filed for payment of this damages claim from property of the estate, and did not limit amount that lessor could recover under letter of credit issued to secure debtor's performance under lease, where lessor never filed proof of claim in bankruptcy case. 11 U.S.C.A. § 502(b)(6).

2 Cases that cite this headnote

[11] **Bankruptcy**
Rejection of executory contract or lease

Cap imposed by the Bankruptcy Code on damages claims asserted by lessors of real property prevents lessor who files claim against estate from reaping an unfair share of bankruptcy estate over the remaining pool of unsecured creditors. 11 U.S.C.A. § 502(b)(6).

1 Cases that cite this headnote

[12] **Bankruptcy**
Letters of credit

Letters of credit issued to secure debtor's performance and proceeds therefrom are not included in "property of the estate." 11 U.S.C.A. § 541(a).

3 Cases that cite this headnote

[13] **Finance, Banking, and Credit**
Relation to underlying transaction; independence principle

Issuer's obligation to beneficiary of letter of credit is independent from any obligation between beneficiary and issuer's customer.

Cases that cite this headnote

[14] **Bankruptcy**
Rejection of executory contract or lease

Claim of lessor against assets of bankruptcy estate is essential precondition to applying damages cap. 11 U.S.C.A. § 502(b)(6).

Cases that cite this headnote

[15] **Bankruptcy**
Debtor's Contracts and Leases

Motion that commercial lessor filed in debtor-lessee's Chapter 11 case to compel payment of past due rent qualified as adequate notice under lease of debtor-lessee's monetary

default, of kind required to permit commercial lessor to draw on letter of credit that secured debtor's performance, pursuant to "monetary default" provision of lease.

Cases that cite this headnote

[16] **Finance, Banking, and Credit**
Letters of Credit
Landlord and Tenant
Acceleration clauses

Once lease was in monetary default, as result of Chapter 11 debtor-lessee's failure to pay past due rent after being notified of its default by commercial lessor's motion to compel payment, lessor could exercise its contractual remedies, including right to accelerate, and thus did not make any negligent misrepresentation in asserting claim against letter of credit which secured debtor's performance for full amount of letter of credit; amount of letter of credit was less than accelerated rent owing under lease.

1 Cases that cite this headnote

[17] **Bankruptcy**
Effect of Acceptance or Rejection

Even assuming that lessor had prematurely drawn on letter of credit that secured Chapter 11 debtor-lessee's performance under lease, by drawing on letter prior to entry of bankruptcy court order approving debtor's announced intent to reject lease, bankruptcy court's subsequent grant of motion to reject *nunc pro tunc* to date of debtor's announced intent, to enable estate to save more than $200,000 in administrative rent expenses if lease were rejected effective only from date of entry of bankruptcy court's order, prevented estate representative from arguing that nunc pro tunc order had not also cured any prematurity in lessor's draw request.

1 Cases that cite this headnote

Attorneys and Law Firms

***263** Robert B. Millner (argued), Sonnenschein, Nath & Rosenthal, Chicago, IL, Gary S. Kessler, Howard C. Rubin, Kessler & Collins, Dallas, TX, for Appellant.

Jaime Lynn Myers, David W. Elmquist (argued), Winstead, Sechrest & Minick, Dallas, TX, for Appellee.

Appeal from the United States District Court for the Northern District of Texas.

Before KING, Chief Judge, and JOLLY and DENNIS, Circuit Judges.

Opinion

PER CURIAM:

The trustee (the "Trustee") of the liquidating trust established under the confirmed Chapter 11 plan of Stonebridge Technologies, Inc. ("Stonebridge") brought an adversary action, as lessee (the "Lessee"), against EOP–Colonnade of Dallas Limited Partnership ("EOP" or the "Lessor"), the lessor, in connection with EOP's draw on a letter of credit that was provided as security for Stonebridge's commercial lease obligations with EOP. The Trustee asserted, in the bankruptcy court, that EOP breached the lease and made negligent misrepresentations to the issuing bank by prematurely drawing on the letter of credit and retaining an amount in excess of the claim cap of 11 U.S.C. § 502(b)(6). The bankruptcy court found that EOP did breach the lease and made negligent misrepresentations by prematurely drawing ***264** on the letter of credit and retaining an amount in excess of the § 502(b)(6) cap. The district court affirmed the bankruptcy court's order, and EOP now appeals. We REVERSE. Because EOP did not file a claim in the bankruptcy case, we hold that the § 502(b)(6) cap was not triggered. Further, we hold that EOP did not prematurely draw on the letter of credit. EOP, therefore, did not breach the lease or make negligent misrepresentations to the issuing bank.

I

On September 21, 2000, EOP and Stonebridge entered into a lease ("Lease"), in which Stonebridge agreed to lease space in an EOP-owned office building. Under the terms of the Lease, Stonebridge was required to provide a security deposit to EOP, defined as "$105,298.85 in cash and a letter of credit in the amount of $1,430,065.74."

Stonebridge provided EOP with a cash payment of $105,298.85 and an irrevocable stand-by letter of credit for $1,430,065.74 ("Letter of Credit") issued by the Bank of Oklahoma ("Bank") in favor of EOP. Stonebridge executed a note payable to the Bank, secured by a certificate of deposit for $1,250,000, to reimburse the Bank in the event of a draw on the Letter of Credit.

On September 6, 2001, Stonebridge filed a Voluntary Petition under Chapter 11 of the United States Bankruptcy Code. At the time of the filing, Stonebridge owed EOP $71,895.61 for miscellaneous charges and expenses plus rent for September 2001. After filing the bankruptcy petition, Stonebridge paid EOP $50,000 to be applied against September 2001 post-petition rent. Stonebridge also initiated negotiations with EOP to reduce its lease obligations, seeking an agreement to reject the Lease as soon as possible and enter into a new short-term lease.

On October 23, EOP and Stonebridge announced an agreement in open court that the Lease would be rejected effective no earlier than October 1, 2001 and no later than October 23, 2001. It became clear at this time that the parties intended the effective rejection date to occur within that window of time, regardless of when the bankruptcy court issued its final order approving the rejection.

Prior to the October 23 court appearance, EOP initiated a draw request on October 22 to the Bank under the Letter of Credit for the full amount of the Letter of Credit. The Bank received the draw request on October 23, but refused to honor it because the request was technically deficient. Three days later, after correcting the deficiencies, EOP delivered another draw request to the Bank. The Bank received and promptly processed the second draw request, which became effective as of October 25. The Bank honored the Letter of Credit on October 30 by issuing a check for $1,430,965.74 and delivering it to EOP.

On November 8, the bankruptcy court entered a *nunc pro tunc* order approving the rejection of the Lease, rendering the rejection effective as of October 1, 2001. As part of the agreement to reject the Lease, EOP was allowed an administrative post-petition rent claim in the amount of $42,137.50, and the parties agreed that pre-petition rent due from September 1 to September 5 was $17,549.81. The record conclusively demonstrates, however, that EOP never filed a proof of claim for its actual lease rejection damages following the bankruptcy court order rejecting the lease and approving EOP's administrative rent claim.

On December 12, the Bank sought relief from the automatic stay to apply Stonebridge's ***265** certificate of deposit as reimbursement for EOP's draw on the Letter of Credit. The Trustee reached a compromise with the Bank, allowing the certificate of deposit to be applied in exchange for an assignment of the Bank's claims against EOP for the allegedly improper draw upon the Letter of Credit. The Trustee then brought this adversary action in the bankruptcy court alleging that EOP breached the Lease and, as assignee, alleging that EOP made negligent misrepresentations to the Bank, by prematurely drawing on the letter of credit and retaining an amount in excess of the § 502(b)(6) cap.

The bankruptcy court held that EOP prematurely drew on the Letter of Credit and retained an amount in excess of the § 502(b)(6) cap, resulting in a breach of the Lease and negligent misrepresentations to the Bank that the funds were "due and owing." *In re Stonebridge Technologies,* 291 B.R. 63 (Bankr.N.D.Tex. Apr.4, 2003). In ruling in favor of the Trustee, the bankruptcy court reasoned that because the Letter of Credit was part of the security deposit, it was subject to the § 502(b)(6) cap. The bankruptcy court also found that EOP's draw of the full amount of the Letter of Credit before the entry of the *nunc pro tunc* Lease rejection order was a breach of the Lease and constituted a negligent misrepresentation to the Bank that the full sum of the Letter of Credit was "due and owing." The bankruptcy court awarded to the estate: (i) damages in the amount of $180,065.74 for EOP's negligent misrepresentation to the Bank, calculated by the difference between the amount EOP drew on the Letter of Credit and the amount the Bank received from the certificate of deposit securing its obligations against the Stonebridge estate; and (ii) damages in the amount of $2,267.23 for EOP's breach of the Lease, calculated by the difference between what EOP would have been entitled to claim under 11 U.S.C. § 502(b)(6) (less a cash security deposit) and the amount the Bank collected on the certificate of deposit. EOP appealed to the district court, and the district court affirmed the bankruptcy court's ruling on January 30, 2004. EOP now appeals.

II

A

[1] We apply the same standard of review as the district court: the bankruptcy court's conclusions of law and mixed questions of law and fact are reviewed *de novo*. *AT&T Universal Card Servs. v. Mercer (In re Mercer),* 246 F.3d 391, 402 (5th Cir.2001) (en banc). Findings of fact are reviewed for clear error. *Id.*

B

[2] We must begin our consideration of this case by examining the jurisdiction of the bankruptcy court (and by extension the jurisdiction of the district court and this court). Neither party has raised jurisdictional issues,[1] but we are obligated to raise the matter *sua sponte*, certainly when jurisdiction appears questionable. *See In re Bass,* 171 F.3d 1016, 1021 (5th Cir.1999).

This appeal considers four claims brought by the Trustee against EOP in an adversary proceeding arising from Stonebridge's bankruptcy. Two claims directly relate to damage allegedly done directly to the estate by EOP's actions: (1) breach of the Lease by prematurely drawing on the ***266** Letter of Credit and (2) breach of the Lease by retaining an amount in excess of the § 502(b)(6) cap. The other two claims were assigned to the Trustee by the Bank: (3) negligent misrepresentation to the Bank that sums were "due and owing" by prematurely drawing on the Letter of Credit and (4) negligent misrepresentation to the Bank that sums were "due and owing" by drawing proceeds in excess of the § 502(b)(6) cap.

District courts have jurisdiction over bankruptcy cases, and they may refer cases at their discretion to bankruptcy courts. 28 U.S.C. § 1334 (district court jurisdiction); 28 U.S.C. § 157 (bankruptcy court jurisdiction). The jurisdictional grant to the bankruptcy court is divided into "core" and "non-core" proceedings. Core proceedings arise under title 11 or arise in a case under title 11. 28 U.S.C. § 157(b). Non-core proceedings are those proceedings that are otherwise related to a case under title 11. 28 U.S.C. § 157(c)(1). Bankruptcy judges may enter all appropriate orders and judgments in core proceedings, but unless the parties consent to core treatment, a bankruptcy judge must submit proposed findings of fact and conclusions of law in non-core proceedings to the district court. 28 U.S.C. § 157(b)-(c).

[3] [4] [5] To determine whether a particular matter falls within general bankruptcy jurisdiction, we ask whether the outcome of that proceeding could have any conceivable effect on the estate being administered in bankruptcy. *Wood v. Wood (In re Wood),* 825 F.2d 90, 93 (5th Cir.1987). More specifically, an action is related to bankruptcy if "the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate." *In re Majestic Energy Corp.,* 835 F.2d 87, 90 (5th Cir.1988) (quoting *Pacor Inc. v. Higgins,* 743 F.2d 984, 994 (3d Cir.1984)). This inquiry is straightforward with respect to the breach of the Lease claims: The Lease is property of the bankruptcy estate in this case and, therefore, any breach of the Lease has an effect on the estate. Any recovery on the claims brought by the bankrupt for breach of the Lease goes directly to the estate for damage done to the estate.

[6] With respect to the claims for negligent misrepresentations that EOP made to the Bank, jurisdiction is less obvious. Although the claims are now owned by the estate by virtue of the assignment to the Trustee, they arise from litigation rights of a third party, the Bank. At first glance, one might conclude that because the estate stands in the shoes of the Bank, and the bankruptcy court had no jurisdiction to litigate the Bank's claim against EOP, the bankruptcy court could not assert jurisdiction over the claim just because the Bank's cause of action had been assigned to the estate.[2] Finding that assignment alone creates bankruptcy jurisdiction to litigate a third party's cause of action defeats the limited scope of bankruptcy jurisdiction. Upon closer review, however, additional effects on the estate are evident: a claim by the Bank against EOP affects the need for the Bank to seek reimbursement from Stonebridge's bankruptcy estate. EOP's draw on the Letter of Credit triggered Stonebridge's contractual responsibility to reimburse the Bank for the draw on the Letter of Credit. Here, however, the Bank also sought damages against EOP ***267** for negligent misrepresentation. If the Bank is successful against EOP on its negligent misrepresentation claims, the need for reimbursement from Stonebridge's estate is alleviated.[3] This effect on the estate is not altered because the Trustee exchanged reimbursement to the Bank for an assignment of the Bank's negligent misrepresentation claims. The negligent misrepresentation claims therefore fall within the general bankruptcy jurisdiction.

[7] [8] Having decided that all four claims are within the

general bankruptcy jurisdiction, we then must decide whether the claims are core or non-core. A proceeding is core "if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case." *Wood*, 825 F.2d at 97. Again, this inquiry is relatively easy with respect to the breach of the Lease claims. Although the breach of the Lease claims are grounded in state contract law, the controlling questions for this case involve the interpretation of substantive rights provided by title 11, the § 502(b)(6) cap and lease rejection under § 365(a).

[9] On the other hand, claims between third parties, such as the negligent misrepresentation claims, are typically considered within the bankruptcy court's non-core jurisdiction. In this case, however, the negligent misrepresentation claims are dependent upon the interpretation of rights created in bankruptcy, specifically those rights associated with § 502(b)(6) and § 365(a). Although the grafting of bankruptcy terms onto the interpretation of a Lease does not automatically result in core jurisdiction, as a practical matter, these particular negligent misrepresentation claims are substantively related to the interpretation of rights created in bankruptcy. In other words, the substantive rights asserted by the Trustee could arise only in the context of a bankruptcy case. Because these claims are dependent upon the rights created in bankruptcy and would not exist but for the filing of Stonebridge's bankruptcy, we find that these claims should be included within the bankruptcy court's core jurisdiction. *See generally Northern Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982) (defining the limits of Article III jurisdiction of bankruptcy courts, later codified into core and non-core jurisdiction by Bankruptcy Amendments and Federal Judgeships Act of 1984, P.L. No. 98–353).

In sum, the bankruptcy court had core jurisdiction over all of the claims currently on appeal from the adversary proceeding under 28 U.S.C. § 1334 and § 157(b). The district court had jurisdiction to review the bankruptcy court's order under 28 U.S.C. § 158(a). We then have jurisdiction to review this appeal under § 158(d), so we proceed to address the merits.

C

For ease of substantive analysis, we consider the causes of action alleged by the Trustee against EOP together (breach of the Lease and negligent misrepresentation[4]), but divide the claims into two ***268** groups: (1) the claims for draw/retention in excess of the § 502(b)(6) cap and (2) the claims for premature draw.

1

[10] We first examine the claims against EOP for drawing against the Letter of Credit an amount in excess of the § 502(b)(6) cap.[5]

[11] Section 502 of the Bankruptcy Code, entitled "Allowance of claims or interests", provides that claims or interests are deemed allowed unless a party in interest objects. 11 U.S.C. § 502(a). If an objection is made, the court determines the amount of such a claim and allows the claim in the determined amount, except to the extent that certain specified conditions exist. 11 U.S.C. § 502(b). Section 502(b)(6) provides:

> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—
>
> > (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
> >
> > > (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
> > >
> > > (i) the date of the filing of the petition; and
> > >
> > > (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
> > >
> > > (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

This limitation prevents a lessor who files a claim against the estate from reaping an ***269** unfair share of the bankruptcy estate over the remaining pool of unsecured

creditors. S.Rep. No. 95–989, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5849; H.R.Rep. No. 95–595, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6309 (the purpose of the statute is "to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend of the estate.").

[12] [13] In this case, the Lessor's need to file a claim against the bankruptcy estate was obviated by the fact that the Lessee's obligations were substantially secured by cash and a letter of credit, to which the Lessor turned when the Lessee defaulted.[6] The Lessor's draw on the letter of credit is the focus of the Trustee's arguments. It is well-established in this circuit that letters of credit and the proceeds therefrom are not property of the debtor's bankruptcy estate. *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.),* 831 F.2d 586, 589 (5th Cir.1987). Insofar as letters of credit embody obligations between the issuer and beneficiary, such contractual rights and duties are entirely separate from the debtor's estate:

> [A]n issuer's obligation to the letter of credit's beneficiary is *independent* from any obligation between the beneficiary and the issuer's customer. All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all the duties required by the letter of credit.
>
> *Id.* at 590 (emphasis added). The structure of this relationship between the beneficiary (EOP), issuer (Bank), and issuer's customer (Stonebridge) is referred to as the "independence principle."

[14] By its terms, § 502(b) applies only to claims against the bankruptcy estate.[7] *See, e.g., In re SKA! Design, Inc.,* 308 B.R. 777, 781 (Bankr.N.D.Tex.2004) ("Section 502 deals only with allowance by a landlord of a claim, *if presented,* against the bankruptcy estate.") (quoting *In re Mr. Gatti's, Inc.,* 162 B.R. 1004 (Bankr.W.D.Tex.1994) (emphasis added)). Claims under § 502(b) are not automatically assumed simply because the debtor assumes or rejects a lease under § 365, but rather must be formally filed against the estate in the bankruptcy court. *See In re National Gypsum Co.,* 208 F.3d 498, 505 (5th Cir.2000) (finding that the "opportunity" to file a proof of claim arises only "*subsequent to the debtor's decision on how to treat the contract or lease*"); ***270** *In re Austin Dev. Co.,* 19 F.3d 1077, 1084 (5th Cir.1994) (finding that assumption or rejection of a lease simply entitles lessor to then file a proof of claim). Stated simply, the claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all. *See In re Arden,* 176 F.3d 1226, 1229 (9th Cir.1999) ("[Section 502(b)(6)] has two predicates: 'claim of a lessor' and 'damages resulting from the termination of a lease or real property.' "). Thus, the damages cap of § 502(b)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter of credit unless and until the lessor makes a claim against the estate.[8] We find, therefore, that further inquiry into the appropriate interpretation of § 502(b)(6) is unnecessary in this case because EOP did not file a claim against the estate.

Nonetheless, Stonebridge argues that the bankruptcy court reached the correct conclusion by limiting EOP to the capped amount.[9] Stonebridge asserts that the Letter of Credit is part of the Security Deposit under the Lease, thus bringing it within the purview of the § 502(b)(6) damages cap. In essence, Stonebridge argues that landlords may not offset actual damages against their security deposit and then claim for the balance under § 502(b)(6). Security deposits "will be applied in satisfaction of the claim that is allowed under [§ 502(b)(6)]." H.R.Rep. No. 95–595, at 353–55. To the extent that a landlord has a security deposit in excess of the amount of his claim under § 502(b)(6), Stonebridge asserts that the excess returns to the bankruptcy estate.

One problematic aspect of this argument is that it converts § 502(b)(6) into a self-effectuating avoiding power that would allow the trustee to bring an adversary proceeding against a lessor who exercises his rights under a letter of credit. This departs from the plain language of § 502(b)(6), which "allows only one thing—disallowance of the filed claim to the extent that it exceeds the statutory cap." Laura B. Bartell, *The Lease Cap and Letters of Credit: A Reply to Professor Dolan,* 120 Banking L.J. 828, 835–36 (2003) ("Unlike preference law, there is no provision of the Bankruptcy Code that allows the trustee to sue a lessor for receiving property, even property of the estate, merely because it exceeds the lease cap of Section 502(b)(6)."). When the Bankruptcy Code intends to create an avoidance power, it does so expressly in the language of the provision. *See, e.g.,* 11 U.S.C. § 547(b); *see also Union Bank v. Wolas,* 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991) (interpreting the scope of a trustee's avoidance powers provided under § 547). Stonebridge's argument draws an implicit analogy between the power of trustees to avoid certain preferential transfers for the benefit of the estate and the statutory cap imposed on a lessor's lease-rejection damages claim under § 502(b)(6) that simply cannot be squared with language in the Bankruptcy Code.

Moreover, Stonebridge relies on two cases from other circuits that have treated ***271** the proceeds of a letter of credit as a security deposit and capped by § 502(b)(6): *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.),* 324 F.3d 197 (3d Cir.2003), and

Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.), 306 B.R. 295 (9th Cir. BAP 2004). In both cases, however, the landlord filed a claim against the bankruptcy estate seeking lease-rejection damages in excess of the amount of the security deposit. Thus, the Trustee's reliance on these two cases is misplaced, because the record conclusively demonstrates that EOP never filed a proof of claim against the Stonebridge estate.

In sum, § 502(b)(6) does not alter the entitlement of EOP to the full proceeds of the Letter of Credit in the case where EOP has not also filed a claim against the estate for recovery of unpaid lease monies. The bankruptcy court's conclusion to the contrary was in error.

2

We next examine the claims against EOP for prematurely drawing against the Letter of Credit. The district court affirmed the bankruptcy court's holding that EOP breached the Lease and made negligent misrepresentations to the Bank by drawing down on the Letter of Credit prior to an event of default. The Lease provides:

> Landlord may, from time to time, without prejudice to any other remedy, use all or a portion of the Security Deposit to satisfy past due rent or to cure any uncured default by Tenant.

The Lease further defines the following as events of default:

> A. Tenant's failure to pay when due all or any portion of the Rent, if the failure continues for 5 days after written notice to Tenant ("Monetary Default").
>
> B. Tenant's failure (other than Monetary Default) to comply with any term, provision or covenant of this Lease, if the failure is not cured within 20 days after written notice to Tenant ....
>
> C. Tenant or any Guarantor becomes insolvent, makes a transfer in fraud of creditors or makes an assignment for the benefit of creditors, or admits in writing its inability to pay its debts when due ....

(a)

EOP asserts three separate reasons that it was entitled to the full proceeds of the Letter of Credit at the time of the draw. First, EOP argues that it did not prematurely draw down on the Letter of Credit because Stonebridge was in Monetary Default when EOP initiated the draw on the Letter of Credit. EOP contends that its motion to compel payment of unpaid post-petition rent filed seven days prior to EOP's initiation of the draw on the Letter of Credit (and served on Stonebridge's attorneys) provided written notice of Stonebridge's past due rent. Furthermore, Stonebridge acknowledged that it was in Monetary Default when it agreed that EOP was owed pre– and post-petition rent as of the rejection date. EOP contends that it was entitled to the proceeds of the Letter of Credit to cure Stonebridge's Monetary Default.

EOP also argues that it was entitled to the proceeds of the Letter of Credit because Stonebridge triggered the Insolvency Clause. Although 11 U.S.C. § 365(e)(1) prohibits the enforcement of such *ipso facto* clauses against the debtor, EOP argues that its ability to enforce its rights in the Lease against a third party letter of credit issuer is not affected by the Bankruptcy Code. Accordingly, at the time that the draw was initiated, EOP exercised its rights against the Bank under a current ***272** default and therefore did not prematurely draw on the Letter of Credit.

Finally, EOP maintains that it was entitled to the proceeds of the Letter of Credit as lease-rejection damages. EOP asserts that the bankruptcy court's November 8 entry of its *nunc pro tunc* order approving rejection of the Lease effective as of October 1 makes EOP's draw on the Letter of Credit valid. Because the retroactive order set the effective date of rejection at October 1, the draw in late October, if in error, would have been cured.

On the other hand, Stonebridge asserts that EOP drew on the Letter of Credit prior to any event of default entitling EOP to the full amount of the Letter of Credit. Stonebridge argues: (1) that there were no Monetary Defaults under the Lease that entitled EOP to the full amount of the Letter of Credit; (2) that EOP was not entitled to draw on the Letter of Credit based on Stonebridge's insolvency under 11 U.S.C. § 365(e)(1); (3) that the bankruptcy court's November 8 order did not retroactively authorize EOP's draw on the Letter of Credit; and (4) that the language of the Lease did not give EOP the right to satisfy EOP's rejection damages with the

proceeds of the Letter of Credit.

(b)

[15] We have determined earlier that § 502(b)(6) was not triggered in this case and did not, therefore, cap damages payable under the Letter of Credit from the Bank to EOP. We now turn to the question of whether other factors limited damages that EOP could claim under the Letter of Credit. With the exception of the question of the timing of the lease rejection under § 365(a) (which is a question of interpreting the Bankruptcy Code and the orders issued therewith), the resolution of this question is a matter of interpreting the Lease. EOP's draw on the Letter of Credit must be supported by some provision of the Lease that rightfully entitles EOP to represent to the Bank that such funds were "due and owing."

We conclude that EOP was entitled to draw on the Letter of Credit under the "Monetary Default" provision of the Lease. At the time of the draw, we have no doubt that Stonebridge was in Monetary Default under the terms of the Lease.[10] To the extent that the bankruptcy court held otherwise by stating that "Landlord EOP never provided notice of monetary or nonmonetary default to Stonebridge," *In re Stonebridge Technologies*, 291 B.R. at 72, the bankruptcy court's conclusions are incorrect. The Lease clearly provides that Stonebridge would be in Monetary Default if it failed to pay its rent when due or any portion of the rent and failed to cure within five days of written notice. EOP's motion for payment of rent was made on October 15, 2001, seven days before EOP actually drew on the Letter of Credit and provided sufficient written notice to Stonebridge that the Lease was in Monetary Default. *See LA–Nevada Transit Co. v. Marathon Oil Co.*, 985 F.2d 797, 800 (5th Cir.1993) (holding that a notice is effective if "sufficiently clear to apprise the other party of the action being taken"). Thus, ***273** the bankruptcy court clearly erred in finding that EOP never provided adequate notice of Monetary Default to trigger its right to draw upon the Letter of Credit.

[16] Once the Lease was in Monetary Default, EOP became entitled to seek remedies, including drawing down all or a portion of the Security deposit, to cure that default under the terms of the Lease. The Lease also contains an acceleration clause under which

> Landlord may elect to receive as damages the sum of (a) all Rent accrued through the date of the termination of this Lease or Tenant's right to possession, and (b) an amount equal to the total Rent that Tenant would have been required to pay for the remainder of the Term discounted to present value at the Prime Rate ... then in effect, minus the present fair rental value of the Premises for the remainder of the Term, similarly discounted, after deducting all anticipated Costs of Reletting.

This clause provides a measurement of lease rejection damages that the Lessor can utilize in the event of a default. In fact, the measure used to calculate accelerated damages under the Lease is the same measure that would be used to calculate the damage to a lessor from the rejection of a lease when not applying the § 502(b)(6) cap. *See* 11 U.S.C. § 502(g) ("A claim arising from the rejection ... of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined ... as if such claim had arisen before the date of the filing of the petition."); *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 443, 57 S.Ct. 292, 81 L.Ed. 324 (1937) ("The amount of the landlord's claim for the loss of his lease necessarily is the difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth."); Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR.INST. L.REV. 733, 761 (2001) (noting that the terms of the lease agreement should be used to calculate damages when the statutory cap of § 502(b)(6) is not involved). Applying this formula in the instant case, EOP's accelerated damages under the Lease (estimated at between $1.5 and $1.6 million) exceeded the value of the Letter of Credit ($1,430,065.74).

We find, therefore, that the proceeds of the Letter of Credit were correctly applied to cover these accelerated damages. The Lease provides that EOP could use "all or a portion of the Security Deposit to satisfy past due Rent or to cure any uncured default by Tenant." The Letter of Credit, defined under the Lease as a portion of the Security Deposit, may therefore be used to satisfy past due rent or cure any uncured default. Because, in this case, those accelerated damages exceed the value of the proceeds of the Letter of Credit, EOP is entitled to the full proceeds of the Letter of Credit to cure the uncured Monetary Default.

[17] Finally, we reject the Trustee's argument that the draw

was premature based on the fact that the bankruptcy court did not issue its final order granting the administrative rent claims and setting the effective lease rejection date until November 8. First, we note that most courts have held that lease rejection may be retroactively applied. *See In re Jamesway Corp.*, 179 B.R. 33, 37 (1995) ("The majority of courts ... have held that the effective date of rejection is the date of the bankruptcy court's order approving rejection, and that court approval is a condition precedent to effective rejection."). Moreover, the parties' announcement in open court on October 23 clearly evinced Stonebridge's preference for an earlier effective rejection date, which ended up saving the estate over $200,000 in administrative rent ***274** expenses. 8 R. at 1480. We are unwilling to allow Stonebridge to reap the benefits of the retroactive order without also recognizing that the earlier date effectively cured the prematurity of EOP's draw request on the Letter of Credit. *See Browning v. Navarro*, 743 F.2d 1069, 1081 (5th Cir.1984) (applying basic rules of contract interpretation to preserve the intended compromise reached by the parties under the terms of an agreement approved by the bankruptcy court).

Accordingly, EOP did not breach the Lease or negligently misrepresent to the Bank that sums were "due and owing" by drawing the full amount of the Letter of Credit.

III

Thus, we hold that the bankruptcy court has general and core jurisdiction over the claims for breach of the Lease and negligent misrepresentation brought by the Trustee. Finding jurisdiction, we hold that § 502(b)(6) does not apply to cap the proceeds that EOP may claim against the Letter of Credit because EOP never filed a claim for damages against the Stonebridge estate. Further, we hold that the acceleration clause of the Lease permitted the draw on the proceeds of the Letter of Credit by EOP when Stonebridge defaulted on its rent payments. Consequently, there was no breach of the Lease or misrepresentation to the Bank.

For the foregoing reasons, the judgment of the district court affirming the judgment of the bankruptcy court in this adversary proceeding is REVERSED, and the case is REMANDED to the district court for further proceedings consistent with this opinion.

REVERSED and REMANDED.

All Citations

430 F.3d 260, 45 Bankr.Ct.Dec. 166, Bankr. L. Rep. P 80,389

Footnotes

1 Neither party has previously raised the question of general bankruptcy jurisdiction. EOP, however, has raised the question of core versus non-core bankruptcy jurisdiction before both the bankruptcy and district courts.

2 At oral argument before this court, counsel for the Trustee admitted that the assigned claims would not be within the bankruptcy court's jurisdiction if those claims had been brought by the Bank. We do not judge the accuracy of this statement, but note that it is such an intuition that led this Court to raise the question of jurisdiction *sua sponte.*

3 Similarly, other cases that involve litigation between third parties have been found to have an effect on the administration of the bankruptcy estate, including suits by creditors against guarantors and a suit by creditors of a debtor against defendants that allegedly perpetrated a fraud. *See* 3 COLLIER ON BANKRUPTCY ¶ 3.01 (15th ed. rev.2005) (citations omitted).

4 To present a claim of negligent misrepresentation, Stonebridge must prove: (1) EOP made a representation in the course of business, or in a transaction in which EOP had a pecuniary interest; (2) EOP supplied false information for the guidance of the Bank in its business transactions; (3) EOP failed to exercise reasonable care or competence in obtaining or communicating this information; (4) the Bank justifiably relied on the representation; and (5) EOP's misrepresentation proximately caused the Bank pecuniary injury. *See McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787, 791 (Tex.1999). The only disputed issue before us is whether EOP falsely represented to the Bank that the full amount of the Letter of Credit was "due and owing." The inquiries undertaken to determine whether EOP falsely represented to the Bank and whether EOP breached the Lease are identical.
The parties do not raise the issue whether a tort action in the form of a negligent misrepresentation claim is available to the Bank, and thus to the Trustee as assignee of the Bank's claims, under these circumstances. *See generally In re Zamora*, 274 B.R. 268, 274 (Bankr.W.D.Tex.2002) ("With the Code's silence, the presumption is that the normal rules regarding the enforceability of valid assignments apply."). Thus, this opinion does not decide whether such a claim is indeed available to issuers of letters of credit when a misrepresentation is made in connection with a draw upon a letter

of credit and nothing in this opinion should be read to indicate that such a cause of action exists. Because of the parties' failure to address the issue, however, we analyze the Trustee's negligent misrepresentation claim under the elements of the traditional tort action.

5 Although mechanical differences may exist between drawing and retaining funds from a letter of credit, the application of § 502(b)(6) does not turn on these distinctions in this case. *See Eakin v. Cont'l Ill. Nat'l Bank & Trust Co. of Chicago,* 875 F.2d 114, 116 (7th Cir.1989) ("Letters of credit are designed to avoid complex disputes about how much the beneficiaries 'really' owe. The promise and premise are 'pay now, argue later.' ").

6 The filing of a proof of claim serves no purpose if the creditor is secured or has not asserted a claim against the estate. *See* 4 COLLIER ON BANKRUPTCY ¶ 501.01[3][a] (15th ed. rev.2005).

7 EOP first raised this argument in its reply brief in support of its motion for summary judgment in the bankruptcy court. *See* 4 R. at 678 ("In this case, EOP did not make a claim against the Debtor's estate. The 502(b)(6) cap only applies for claims against the estate. Thus, EOP did not have to take the cap into consideration in calculating its damages."). In the district court proceedings, EOP specifically devoted an entire subsection of its brief to this argument. *See* 1 R. at 47–48 ("When a creditor has a claim against a third party arising out of the actions of the debtor, or the creditor's relationship with a debtor, the creditor is not obligated to file a claim against the debtor's estate to pursue its remedy against a third party non-debtor."). This argument was reiterated in the appellant's briefs to this court, which described this proposition as "axiomatic" to the application of § 502(b)(6). Brief of Appellant at 33; *see also* Reply Brief of Appellant at 4–5. Because the record clearly demonstrates that EOP adequately briefed and preserved this argument throughout the lower court proceedings, we find no compelling reason to deem it waived on this appeal. *See Dial One of the Mid–South, Inc. v. BellSouth Telecomms., Inc.,* 401 F.3d 603, 607 (5th Cir.2005).

8 We also note that § 502(b)(6) does not apply to limit administrative expense claims made by the landlord based upon the continued use of the premises after the filing of the bankruptcy petition. *See* 4 COLLIER ON BANKRUPTCY ¶ 501.01[7][g] (15th ed. rev.2005). Thus, this court will not imply a claim for lease-rejection damages in EOP's motion for administrative rent payments.

9 It is undisputed that EOP would have been limited to rejection damages from Stonebridge's estate of $1,353,032.02 under § 502(b)(6) if it had filed a claim against the estate.

10 During the bankruptcy court proceedings, Matthew Koritz, the litigation and government affairs counsel for EOP's general partner, testified that the determination of whether funds were "due and owing" under the Lease at the time of the draw was based upon Stonebridge's failure to pay portions of pre– and post-petition rent and intention to reject the Lease in full as part of its liquidation plan. 8 R. at 1511–12. Based on the formula provided in the acceleration clause of the Lease, EOP calculated its actual rejection damages under the Lease at approximately $1.5 to $1.6 million. 8 R. at 1478. Stonebridge does not dispute this figure.

174 A.D.2d 461
Supreme Court, Appellate Division, First Department, New York.

185 MADISON ASSOCIATES, a Co-partnership, Plaintiff–Appellant,
v.
Tom RYAN, a/k/a Thomas B. Ryan, Defendant–Respondent.

June 18, 1991.

Synopsis

Landlord sued guarantor of tenant's obligation under lease. The Supreme Court, New York County, Tompkins, J., denied landlord's motion for summary judgment and landlord appealed. The Supreme Court, Appellate Division, held that landlord's consent to sublease did not relieve tenant from obligation under lease and did not relieve defendant from personal guarantee of tenant's full performance of lease.

Reversed and motion granted.

West Headnotes (4)

[1] **Guaranty**
Change in Obligation or Duty of Principal
Landlord and Tenant
Liability of sublessor to landlord

Landlord's consent to sublease did not relieve tenant from obligation under lease and did not relieve defendant from personal guarantee of tenant's full performance of lease.

3 Cases that cite this headnote

[2] **Landlord and Tenant**
Liability of lessee after assignment

To relieve original tenant assignor from its continuing liability for rent after assignment, it must be expressly shown that lessor not only consented to assignment, but accepted assignee in place of tenant.

5 Cases that cite this headnote

[3] **Landlord and Tenant**
Liability of lessee after assignment

Release of tenant from liability for rent after assignment must either be express or implied from facts other than lessor's mere consent to assignment and its acceptance of rent from assignee.

9 Cases that cite this headnote

[4] **Guaranty**
General rules of construction

Where lease, including guarantee of tenant's performance of lease, is complete upon its face, guarantor's claim of contradictory oral agreement is insufficient to avoid liability.

Cases that cite this headnote

****245** Before SULLIVAN, J.P., and ROSENBERGER, KUPFERMAN, ROSS and SMITH, JJ.

Opinion

***461** MEMORANDUM DECISION.

Order, Supreme Court, New York County (Harold Tompkins, J.), entered June 22, 1990, which denied plaintiff's motion for summary judgment, unanimously reversed, on the law, and plaintiff's motion is granted, with costs. The clerk is directed to enter judgment accordingly.

[1] [2] [3] [4] Contrary to the finding of the IAS court, there is no conflict between paragraph 40 of the lease which provides that, in the event of a subletting, the tenant, Ryan Consulting Group, Inc., remains responsible for the payment of all rents due under the lease and the clause in Ryan Consulting Group's assignment of the lease to Robert Henkel and Associates, Inc. whereby the assignee agreed to be solely responsible for the rent. The assignment is solely an agreement between the tenant and subtenant and the plaintiff landlord's consent to the sublease did not relieve the tenant from its obligation under the lease or defendant from his personal guarantee of the tenant's full performance of the lease. It is well settled that in order to relieve the original tenant-assignor from its continuing liability after assignment, it must be expressly shown that the lessor not only consented to the assignment, but accepted the assignee in place of the tenant and such release of the tenant must either be express or implied from facts other than the lessor's mere consent to the assignment and its acceptance of rent from the assignee (74 N.Y.Jur.2d, Landlord and Tenant, § 692). Where the lease, including defendant's guarantee, is complete upon its face, defendant's claim of a contradictory oral agreement is insufficient to create an issue of fact or defeat summary judgment.

All Citations

174 A.D.2d 461, 571 N.Y.S.2d 244

KeyCite Yellow Flag - Negative Treatment
Distinguished by 29 Holding Corp. v. Diaz, N.Y.Sup., March 31, 2004

265 A.D.2d 270
Supreme Court, Appellate Division, First Department, New York.

665–75 ELEVENTH AVENUE REALTY CORP.,
Plaintiff–Appellant,
v.
Janet L. SCHLANGER, etc.,
Defendant–Respondent.

Oct. 28, 1999.

Synopsis
Landlord whose judgments against tenant for unpaid rent were unsatisfied brought suit against tenant's guarantor. The Supreme Court, New York County, Emily Goodman, J., denied landlord's motion for summary judgment. Landlord appealed. The Supreme Court, Appellate Division, held that: (1) money judgments in favor of landlord for periods after expiration of written extensions of lease did not bar litigation of issue of whether written lease existed for those periods, and (2) guarantee lapsed upon expiration of final written lease extension, even though tenant stayed in possession.

Affirmed as modified.

West Headnotes (5)

[1] **Judgment**
Nature and Requisites of Former Adjudication as Ground of Estoppel in General

Collateral estoppel only arises if a fact is decided by a court of competent jurisdiction, which is then deemed binding in any further proceeding involving the party against whom it was decided.

Cases that cite this headnote

[2] **Judgment**
Matters Not in Issue

Money judgments rendered in favor of landlord for periods after expiration of written extensions of lease did not operate under doctrine of collateral estoppel to bar litigation of issue of whether written lease existed for those periods in landlord's action against guarantor; money judgments in question were presumably for use and occupancy, to which landlord would be entitled upon expiration of lease.

1 Cases that cite this headnote

[3] **Guaranty**
General Rules of Construction

Terms of guarantee are to be strictly construed in favor of a private guarantor.

11 Cases that cite this headnote

[4] **Guaranty**
Scope and Extent of Liability

A guarantor should not be bound beyond the express terms of his guarantee.

8 Cases that cite this headnote

[5] **Guaranty**
Guaranties of Leases

Written guarantee executed by tenant's guarantor, which created obligation on part of guarantor as to "any renewal, change or extension of" lease, lapsed upon expiration of final written extension of lease, even though tenant stayed in possession of premises.

11 Cases that cite this headnote

Attorneys and Law Firms

****271** Daniel Finkelstein, for Plaintiff–Appellant.

Howard J. Goldstein, for Defendant–Respondent.

ROSENBERGER, J.P., TOM, MAZZARELLI, SAXE and BUCKLEY, JJ.

Opinion

MEMORANDUM DECISION.

***270** Order, Supreme Court, New York County (Emily Goodman, J.), entered September 30, 1998, which insofar as appealed from denied plaintiff's motion for summary judgment, unanimously modified, on the law, and upon a search of the record, summary judgment granted in favor of defendant dismissing the complaint, and as so modified, affirmed, without costs. The Clerk is directed to enter judgment in favor of defendant-respondent dismissing the complaint.

The facts are undisputed. On or about October 13, 1987, Fatice, Inc., a closely-held family-owned company, entered into a written lease with plaintiff-landlord 665–75 Eleventh Avenue Realty Corp. The original lease was executed by defendant Martin Schlanger, in his capacity as president of Fatice. Simultaneously, he also executed a separate written guaranty, which provided in pertinent part:

> The Guarantor further agrees that this guaranty shall remain and continue in full force and effect as to any renewal, change or extension of the Lease.

The lease by its terms ended on October 31, 1992, and from November 1992 through June 1995 Fatice and plaintiff-landlord entered into 25 written extensions of the lease. The final written extension agreement was dated June 1995 (date unspecified), extending the lease to June 30, 1995.

Fatice remained as a month-to-month tenant after the last written lease extension and paid monthly rent at the rate of $8,000 for the months of July, August and September 1995. Beginning in October ****272** 1995, Fatice failed to pay rent and thereafter a non-payment proceeding was commenced against Fatice claiming rents through June 1996. Fatice appeared in this non-payment action and asserted affirmative defenses, including that the lease had expired and that no written rental extension agreement existed. The Civil Court awarded a full money judgment against Fatice, Inc., as well as a later money judgment for additional rent.

Since the judgments remained unsatisfied, plaintiff commenced an action against Martin Schlanger, seeking enforcement of the guaranty he executed. Defendant Schlanger (now deceased) interposed an answer containing various affirmative defenses, including the same defense raised ***271** by Fatice, Inc. in the summary non-payment proceeding, *i.e.*, claiming that no lease extension existed between the parties after June 1995. Both sides moved for summary judgment. The Supreme Court (Emily Goodman, J.), granted the landlord's motion to the extent of striking each of the guarantor's affirmative defenses, but denied summary judgment. The landlord appeals, claiming that it was entitled to summary judgment on its guaranty claims.

The landlord's principal argument on appeal is that the doctrine of collateral estoppel bars the guarantor's position that no extension of the lease existed between the parties, because the Civil Court had previously ruled that the corporate tenant was liable for the rent and the guarantor was in privity with the corporate tenant.

[1] [2] However, the Civil Court made no findings with respect to whether or not there was an extension of the lease after June 30, 1995. Collateral estoppel only arises if a fact is decided by a court of competent jurisdiction, which would then be deemed binding in any further proceeding involving the party against whom it was decided. The money judgments rendered by the Civil Court for the period subsequent to the final written extensions of the lease were presumably for use and occupancy, to which the landlord would be entitled upon expiration of the lease.

[3] [4] [5] The terms of the guaranty, which are to be strictly construed in favor of a private guarantor (*see, Levine v. Segal*, 256 A.D.2d 199, 200, 682 N.Y.S.2d 375), only create an obligation on the part of the guarantor as to "any renewal, change or extension of the Lease." Since a "guarantor should not be bound beyond the express terms of his guarantee" (*Wesselman v. Engel Co.*, 309 N.Y. 27, 30, 127 N.E.2d 736), and since it is undisputed that there was no written lease extension beyond June 10, 1995, the guaranty lapsed, releasing the defendant from liability

under the lease.

265 A.D.2d 270, 697 N.Y.S.2d 270, 1999 N.Y. Slip Op. 08868

All Citations

End of Document

Topic VI

Letters of Credit and Guarantees

By
Bruce J. Leuzzi, Esq.

I. **Security:**

(i) **Why?**

(a) Generally, it is "security for the faithful performance and observance by Tenant of the terms, provisions and conditions of this lease" (REBNY lease form).

(b) It can also or only be security for limited purpose(s) – fixed rent; certain monetary terms; all monetary terms; certain non-monetary obligations (completion of alterations, removal of alterations).

(c) It can be a complement to a "normal" security deposit, tailored to a specific obligation of the tenant that the landlord is specifically concerned about. For example, a completion guaranty to secure a tenant's obligation to build-out a space, or a "good guy" guaranty to incentivize the tenant to surrender the space without a fuss if it can't pay the rent and enable the landlord to quickly and painlessly obtain the premises from the tenant without having to expend unrecoverable sums and significant time utilizing the legal process.

(d) Can also be required at a later date if warranted, e.g., security if the tenant seeks to make a significant alteration or contest a law.

(ii) **What?** Amount (unless legally limited to 1 month - see rent regulation discussion below) and/or type usually handled in advance as part of the business negotiations. Depends on strength of tenant and strength of landlord/marketplace.

(a) Generally, can consist of all or any of the following: cash, irrevocable standby letter of credit ("**ISLOC**"), or guaranty. There are also other types for specific circumstances, e.g., bonding tenant's work or a mechanic's lien arising out of tenant's work.

(b) Security can be altered during the term per a fixed schedule linked to a tenant's good conduct benchmarks. For example, if no Default/Event of Default occurs and rent has not been paid late, (cash) security will be reduced by the following amount(s) on (each of) the following date(s): on _____ by $_____ to $_____; on _____ by $_____ to $_____; and on _____ by $_____ to $_____.

(c) Can be supplemented if certain conditions warrant, and tailored to those conditions. For example, if the tenant seeks to make particularly expensive improvements, the landlord may require additional security (e.g., a completion guaranty or additional cash security) to ensure lien free completion, or, if the tenant has made an improvement that is particularly expensive to remove at the end of the term and the tenant is obligated to remove that item at the end of the term, the landlord may require specific security to assure itself that that item will be removed at the end of the term at the tenant's expense.

(d) Can be increased for the balance of the lease term in certain circumstances, for example, if the lease is "Assigned", if a check bounces, or if a "Default" occurs.

(e) Generally, residential tenants cannot be required to pledge their personal property as security for rent (RPL §231).

(f) "The amount of a security deposit for a rent regulated apartment is generally limited by law to one month's rent. It is unlawful for the owner to ask for an additional amount of money from the tenant, guarantor or third party. If two months' security deposit was

collected from a tenant by the owner when the apartment first came under rent stabilization, and the same tenant is still occupying the apartment, the owner must refund to the tenant any additional security deposit which exceeds one month's rent when the tenant reaches the age of 65, or receives Social Security disability retirement benefits or SSI benefits. The next rent stabilized tenant cannot be required to deposit more than one month's rent as security deposit. . . . . When a lease is renewed at a higher rental amount, or the rent is increased during the term of the lease, the owner can collect additional money from the tenant to bring the security deposit up to the new monthly rent. Even though a tenant may be exempt from paying a lease increase because of his or her Senior Citizen Rent Increase Exemption (SCRIE), (See Fact Sheet #21, Special Rights of Senior Citizens), or Disability Rent Increase Exemption (DRIE), (See Fact Sheet #20, Special Rights of Disabled Persons), the tenant must still pay the increased security." NYS DHCR Fact Sheet No. 9: Renting an Apartment - Security Deposits and other Charges.

(iii) **When can the landlord use it?**

(a) Subject to negotiation. For "typical" security - if there is a breach (small "d" default), or an Event of Default (defined term – after notice and failure to cure (if any) has expired).

(b) For residential, "(a) landlord may use the security deposit as a reimbursement for any unpaid rent, or the reasonable cost of repairs beyond normal wear and tear, if the tenant damages the apartment." Tenant's Rights Guide, Office of the NYS Attorney General.

(iv) **Must the tenant replenish the security?**

(a) If it's cash or an ISLOC, make sure that the lease states that the tenant has to replenish any security that has been used by the landlord, and that any payment due is additional rent.

1. The landlord can, following the terms of the lease, either bill the tenant for a payment the landlord has made or deduct the amount from security. In the latter case, make sure that the tenant has the written obligation to restore any applied security.

(1) REBNY – All 3 leases state that "Tenant has deposited (the security)". The tenant has therefore satisfied the fixed obligation to deposit the security and does not have a continuing obligation to keep the security at that amount if the landlord applies some or all of it. The newest forms (04) specify that the tenant's failure to redeposit applied security is a default; older Store and Office Lease forms do not. Fix this with a rider to the Store and Office form. Without the security replenishment requirement, the landlord should leave the security alone and bill the tenant for the amount due as additional rent, unless the tenant is broke.

(v) **When must the landlord return security?**

(a) At the end of the lease or a reasonable period of time after the term ends, less any lawful deduction. Reasonable means 21 – 45 days. Like all things reasonable, look at the circumstances. If there are real surviving obligations, such as existing lawsuits, indemnity issues, insurance issues, environmental issues, and condition of premises issues, landlord has reason to hold on to the security, or at least some of it. Or as the lease specifies.

(b) If an ISLOC, if it has expired, then the landlord cannot draw on it.

(c) If Guaranty, the Guarantor should request the original.

II. **Cash vs. Irrevocable Standby Letter of Credit vs. Guaranty. Can be used individually or in combinations.**

(i) **<u>Generally</u>**

(a) GOL §7-105 applies to "a sum of money or any other thing of value" deposited with the (sub)landlord "as security for the full performance by such tenant or licensee of the terms of his lease or license agreement."

1. It requires that the seller/assignor "at the time of the delivery of the deed or instrument or assignment or within five days thereafter, or within five days after the receiver shall have qualified, deal with the security deposit as follows:" "(t)urn over" to the grantee or assignee "the sum so deposited . . .and notify the tenant or licensee by registered or certified mail of such turning over and the name and address of such grantee, assignee, purchaser or receiver." GOL §7-105(1).

2. If the transferor turns over the "amount of such security deposit", it is "relieved of and from liability to the tenant or licensee for the repayment thereof," and that obligation becomes the transferee's obligation. GOL §7-105(2). "The provisions of this section shall not apply if the agreement between the landlord and tenant or licensee is inconsistent herewith." GOL §7-105(2)

3. Violation of GOL §7-105 is a misdemeanor. GOL §7-105(3).

(b) Look also at GOL §7-107 (Liability of a grantee or assignee for deposits made by tenants upon conveyance of rent stabilized dwelling units), GOL §7-108 (Liability of a grantee or assignee for deposits made by tenants upon conveyance of non-rent stabilized dwelling units), and GOL §7-109 (Commencement of a proceeding or action by the attorney general to compel compliance).

(ii) **<u>Cash</u>** – the landlord should follow the rules and hold the security correctly as the failure to do so could result in the tenant obtaining the security before the term ends.

(a) It's the tenant's/depositor's money (including interest earned on it), must be held in trust by the landlord, and may not be commingled with the landlord's money. GOL §7-103(1).

(b) If the landlord deposits the security in a banking organization, the banking organization must have a place of business in NY State. The landlord must notify the tenant of the name and address of the banking organization, and the amount of the deposit, ***<u>after</u>*** it makes the deposit (so lease provision stating all of this information may not suffice since typically the lease is signed before the security is deposited). GOL §7-103(2).

(c) ***<u>If</u>*** the security is placed in an interest bearing account, landlord may collect an administrative fee equal to 1% of the security annually "in lieu of all other administrative and custodial expenses". The balance of the interest is the tenant's/depositor's money, and is either held in trust for that party until repaid or used, or paid to that party annually. GOL §7-103(2).

1. ***<u>But</u>***, if the security is for the rental or property containing 6 or more family dwelling units, "the landlord shall deposit the security in an interest bearing account in a banking organization within the state which account shall earn interest at a rate which

shall be the prevailing rate earned by other such deposits made with banking organizations in such area." GOL §7-103(2-a).

2. ***What if*** the interest rate on the interest bearing account is less than 1%? Can the landlord take the interest the bank pays plus some of the security principal as the administration fee and obligate the tenant to replenish the security to the extent that the landlord has applied it for the 1%? Statutory language does not prohibit this. Not sure a landlord would want to risk this, though.

(d) "In the event that a lease terminates other than at the time that a banking organization in such area regularly pays interest, the person depositing such security money shall pay over to his tenant such interest as he is able to collect at the date of such lease termination." §7-103(2-b)

(e) Cannot overemphasize that the cash is placed "in trust". It certainly is illegally converted if the security is comingled or not segregated, and subject to immediate recovery by the tenant unless the landlord cures before the tenant seeks to obtain the security. The landlord cannot cure this if the attempt to undue the commingling occurs after the expiration of the term and the vacation of the premises by the tenant. *See McMaster v. Pearse,* 804 N.Y.S2d 640 (Civ. Ct. 2005). This case, in footnote 2, states the following: "(i)f the tenant remains in possession and has not sued to recover the deposit, a landlord has the opportunity to cure (Milton R. Friedman, Friedman on Leases § 20.4 [Nature of Security Deposit — Statutes], at 1293 [4th ed, PLI 1997] ["Commingling by landlord is a conversion, which gives tenant an immediate right to recover the deposit without offset by reason of any claim by landlord. Landlord's right to the security is revived if the commingling ceases before tenant brings an action to recover the deposit. But segregation after expiration of the term and vacation by tenant is held too late for such revival"]

1. What happens if the Landlord does not advise the tenant of the name and address of the banking organization, and the amount of the deposit, after it makes the deposit?

(f) The tenant cannot waive the requirements of GOL §7-103. GOL §7-103(3).

(g) Get a W-9 if placing it in an interest bearing account.

(iii) **Irrevocable Standby Letter of Credit (ISLOC)**

(a) **General Overview of Letters of Credit**.

1. Defined in UCC Art. 5 as well as in the UCP and ISP (see below). Three (3) basic parties: an **applicant** (the party requesting the letter of credit – typically the tenant in a commercial lease) applies to an **issuer** (the party who issues the letter of credit – often a bank in a commercial lease) who undertakes to pay the **beneficiary** (the person entitled to payment under the ISLOC – typically the landlord in a commercial lease). Three agreements – between applicant and beneficiary (lease), applicant and issuer (reimbursement agreement), and issuer for the beneficiary (ISLOC, beneficiary does not sign an agreement with the issuer).

2. 2 Basic Types – Commercial Letter of Credit and the Standy Letter of Credit.

a. The **Commercial Letter of Credit** is **the expected source of payment** in a transaction.

b. The **Standby Letter of Credit** acts as a **back-up or guaranty** if the applicant does not fulfill a separate obligation located in a different agreement (e.g., a commercial lease or lease guaranty).

(b) **Two (2) Fundamental Principles of Letters of Credit**.

1. **Independence**. The ISLOC is independent of the contract that brought about the requirement for the letter of credit (e.g., the commercial lease) and the agreement between the applicant and the issuer (e.g., a reimbursement agreement). The ISLOC is to be paid per its terms regardless of what is happening under any of the other agreements. For the ISLOC's purposes, if the beneficiary demands payment per the terms of the ISLOC, the issuer automatically pays it without further inquiry. Any problems or litigation are handled after the payment is made under the ISLOC, not before. UCC Section 5-103(d) (Scope). ISP Rules 1.06(c) (Nature of Standbys) and 1.07 (Independence of the Issuer-Beneficiary Relationship). See also footnote 19 to the ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement.

2. **Strict Documentary Compliance**. If the beneficiary strictly follows the ISLOC's requirements for payment, the issuer will pay the beneficiary – basically, present **what** the ISLOC tells you to present, present it **how** the ISLOC tells you to present it, present it **where** the ISLOC tells you to present it, and present it **by the date** the ISLOC tells you to present it by. The obligation to pay does not arise otherwise. It's supposed to be mechanical – if the beneficiary demands a payment per the ISLOC's requirements, the issuer pays it. Problems typically arise when the beneficiary demands payment right before the ISLOC's expiry date and the demand does not strictly comply with the ISLOC's requirements. UCC Section 5-108 (Issuer's Rights and Obligations). ISP Rule 4.09 (Identical Wording and Quotation Marks).

(c) **Irrevocable Standby Letter of Credit**. **A Letter of Credit is irrevocable and not transferable if it is silent** – it must state it is revocable by the issuer for it to be revocable, and it must state it is transferable by the beneficiary for it to be transferable. UCC Section 5-106(a) and 5-112 (note 5-113 – Transfer by Operation of Law); ISP Rule 1.06(a) and (b) and see footnote 7 to ISP98 Form 1 Model Standby (ISLOC) Incorporating Annexed Form of Payment Demand with Statement.

1. **Irrevocable** - all parties to the ISLOC (issuer (typically a bank) and beneficiary (typically, the landlord) must agree to changes.

2. **Standby** - acts as a guaranty or security if a payment is not made (a default occurs), as opposed to being the method payment is made (which is the case for a commercial ISLOC).

3. **Letter of Credit** - issuer (typically a bank) promises it will pay the beneficiary specified in the ISLOC (typically the landlord) a certain amount of money within a certain time period after a request for the money is made; the bank's credit is substituted or supplemented for the applicant's (typically, the tenant's).

(d) **Pro's and cons for the tenant.** Better use of cash (tenant's return on the cash security sitting with landlord is paltry compared to its return on the same cash if it invests that cash in its business; landlord takes a 1% administration fee on the cash). **But**, they are not free, generally require a Reimbursement Agreement between the issuer (e.g., a

bank) and the applicant (e.g., a tenant) and may require posting collateral; logistical challenges – e.g., keeping track of its location and its expiry date.

(e) **Pro's and cons for the landlord**. Substitutes/supplements a credit worthy party for the tenant; it is supposed to get around the bankruptcy limit on recovery of damages that cash security does not. **But**, the applicant (tenant) and the issuer (bank) might want to make it harder to get the cash by adding a layer of requirements to draw on the ISLOC in the ISLOC in addition to those in the lease; it is uncertain, at best, if it is free of the bankruptcy cap on damages; logistical challenges – e.g., keeping track of its location, its expiry date, the issuer's financial rating (e.g., "(o)nce a bank is in receivership, the FDIC as receiver may reject undrawn standby ISLOC's as burdensome contracts").[1]

(f) **Law**. Interplay of UCC Section 5, and either the Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce, 2007 revision, ICC Publication No. 600 ("**UCP**"), or (b) International Standby Practices (endorsed by the ICC which designates it ICC Publication No.590) ("**ISP98**" or "**ISP**"). Both the UCP and the ISP are copyrighted, you have to buy them. The ISLOC should state which of the UCP or the ISP the ISLOC is subject to; they are not applicable – do not have the force of law – unless they are incorporated into the ISLOC.

1. The ISP is more preferable since it applies specifically to standby letter of credits.[2]
2. UCC Section 5-116(c) allows UCP or ISP to be incorporated into the ISLOC, states UCP/ISP governs if there is a conflict between the UCC and UCP/ISP "except to the extent of any conflict with the nonvariable provisions specified in" UCC Section 5-103(c). The nonvariable provisions are:
    a. 5-103(c), i.e., which provisions of UCC Article 5 are nonvariable;
    b. 5-103(a) and (d), i.e., the scope of Article 5 and the independence principle discussed above;
    c. 5-102(a)(9) and (10) —102. i.e., definition of issuer and letter of credit;
    d. 5-106(d), i.e., expiration of perpetual letter of credit or letter of credit that does not have an expiry date;
    e. 5-114 (d), i.e., "issuer or nominated person has no obligation to give or withhold its consent to an assignment of proceeds of a letter of credit, but consent may not be unreasonably withheld if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honor."
    f. To the extent prohibited by 1-302, Titled Variation by Agreement – subsection (b) notably states that "The obligations of good faith, diligence, reasonableness, and care prescribed by this act may not be disclaimed by agreement"]; and
    g. To the extent prohibited by 5 – 117(d), i.e., when subrogation rights arise – generally, after the ISLOC is paid, thus buttressing the independence principle.
3. See discussion in footnote 19 to ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement.

(g) **Forms**. There is no "standard" form of any ISLOC. ISP has provided a series of suggested forms with excellent footnotes that are not copyrighted. They can be found at http://iiblp.org/banking-law-resources/isp-forms/ (these forms are: Form 1 - Model

Standby Incorporating Annexed Form of Payment Demand with Statement, Form 2 - Model Standby Providing for Extension and Incorporating Annexed Form of Payment Demand with Alternative Non-Extension Statement, Form 3 - Model Standby Providing for Reduction and Incorporating Annexed Form of Reduction Demand, Form 4 - Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand, Form 5 - Simplified Demand Only Standby, Form 6 - Model Counter Standby with Annexed Form of Local Bank Undertaking, Form 7 - Model Standby Requiring Confirmation, Form 8 - Model Confirmation of Standby, and Form 11.1 - Model Government Standby Form). In addition, there is very good form in Chapter 37 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise (Joshua Stein, Esq., Editor in Chief).

1. **Issuance.**
    a. "A letter of credit is issued and becomes enforceable according to its terms against the issuer when the issuer sends or otherwise transmits it to the person requested to advise or to the beneficiary." UCC Section 5-106(a)
    b. The ISLOC is issued when it leaves the issuer's control. ISP Rule 2.03.
2. **Name of the ISLOC.** Name on the ISLOC does not affect the substance of the ISLOC. ISP Rule 1.01(b).
3. **Demand for Draw**. Should be a simple demand by the beneficiary "so that when the beneficiary completes it as indicated, it will include a demand for payment of a stated amount, be dated and signed, and contain any required beneficiary statements."[3] "Straight" ISLOC – from issuer to beneficiary that is not transferable. Not a "draft" since the ISLOC is not negotiable or transferable. Drafts imply that the demand for payment needs to comply with "banking practices" which are not uniform. Should be no need to provide the original ISLOC.[4] Keep the demand simple.[5]
    a. **Amount Available**. The ISLOC should state the amount available. "Under ISP98 Rule 3.08(e) (Partial Drawings & Multiple Presentations; Amount of Drawings), a drawing that exceeds the amount available under the standby is discrepant. To override that rule and require the issuer to pay the full amount available under the standby against a presentation that would comply but for the "credit overdrawn" discrepancy, the following clause may be added: 'If a demand exceeds the amount available, but the presentation otherwise complies, Issuer undertakes to pay the amount available.'" Footnote 6, ISP Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement.
    b. UCC Section 5-111 addresses an **issuer's wrongful dishonor or repudiation** – the beneficiary gets its money and incidental (but not consequential) damages.
    c. **Partial/Multiple Draws**. ISP allows without the ISLOC so stating unless the ISLOC specifically prohibits them. ISP Rule 3.08. The amount available under the ISLOC is reduced by a draw. ISP Rule 1.10(c)(ii).[6]
    d. **Form of Payment Demand**. Annexing form of payment demand not necessary but helpful. Footnote 10, ISP Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement. Consult ISP Rule 4.09 (Identical Wording and Quotation Marks).

e. "ISP98 Rule 2.01(e) (Undertaking to Honor by Issuer and Any Confirmer to Beneficiary) provides that honor by payment is to be made in immediately available funds."[7]

f. See **Manner of Presentation** below

4. **Endorsement**. Should not be necessary to draw as the draw should be without recourse to the beneficiary - the recourse is supposed to be to the applicant only. If beneficiary's signature is required, make clear that it is not an endorsement and merely complying with a demand requirement in the ISLOC and does not subject the beneficiary to recourse liability. Also see Fraud below regarding signatures.[8]

   a. UCC Section 5-110 (Warranties) sets forth the warranties the beneficiary makes to the issuer and the applicant if its presentation is honored ("(t)o the issuer, any other person to whom presentation is made, and the applicant that there is no fraud or forgery of the kind described in subsection (a) of section 5—109 [Fraud and Forgery]" and "(t)o the applicant that the drawing does not violate any agreement between the applicant and beneficiary or any other agreement intended by them to be augmented by the letter of credit.")

   b. UCC Section 5-117 (Subrogation of Issuer, Applicant and Nominated Person). This is not a surety relationship but a primary obligation of the issuer. But, the issuer **that has paid** the beneficiary is subrogated to the rights of the beneficiary and the applicant under the lease as if it was a "secondary obligor" (a surety). The applicant that "reimburses an issuer is subrogated to the rights of the issuer against any beneficiary . . . to the same extent as if the applicant were the secondary obligor of the obligations owed to the issuer and has the rights of subrogation of the issuer to the rights of the beneficiary stated in subsection (a) of this section."

5. **Issued by a Local Bank Only??**

   a. Applicants typically only want to use their banks – if it's not a local bank, applicant will pay an issuance fee to its nonlocal bank for the ISLOC, and then pay another confirmation fee to the local bank to confirm the ISLOC ("confirm" meaning the local bank will honor a demand under the ISLOC issued by another bank or that such demand will be honored by the issuer or by a third bank, assuring the beneficiary that it can obtain payment locally and enforce payment locally).[9]

   b. Beneficiary wants the ISLOC issued by a local bank – the beneficiary does not want to file suit in a distant location that may be friendlier to the issuer using unfamiliar law to enforce the ISLOC; presentation of a demand is more difficult, time consuming, and logistically challenging if it is not local.[10]

   c. But the law is essentially uniform – NY adopted the revised Article 5 of the UCC, as have all other states, and either ISP or UCP is incorporated in all cases.[11]

   d. And, beneficiary can insist the ISLOC provide that the local courts have exclusive jurisdiction and venue. [12]

   e. And, beneficiary can insist in the ISLOC that demand can be made by courier or fax with no requirement that the original ISLOC be provided. Beneficiary can

confirm documents received by a phone call to the issuer. Issuer must advise of problems with demand by telecommunication. [13]

6. **Manner of Presentation**.

   a. "The information in the text of the standby indicating **where, how, and to whom** a presentation is to be made under the standby should be repeated in the demand form. See ISP98 Rules 3.01 (Complying Presentation under a Standby), 3.04 (Where and to Whom Complying Presentation Made), and 3.06 (Complying Medium of Presentation). Particular attention should be given to the possibility that a standby may require presentation at an address that differs from the issuer's letterhead address."[14]

   b. "(U)sual practice (is) sending original documents, sometimes including the original standby, in a package by courier to the issuer's indicated place of presentation. Presentations by telefax and the like are prohibited unless expressly permitted in the standby or unless the beneficiary is a SWIFT participant or bank sending a demand using SWIFT or other similar authenticated means. See ISP98 Rule 3.06 (Complying Medium of Presentation). ISP98 Rule 1.09(c) (Electronic Presentations) includes defined terms that may be used in a standby that permits electronic presentation."[15]

   c. "Standby identification. A demand form should identify the standby by including the information in the standby text that identifies it, particularly the issuer's reference number. See ISP98 Rules 3.01 (Complying Presentation under a Standby) and 3.03 (Identification of Standby)."

   d. See **Demand Date** in **Time of Presentation** below.

7. **Place of Presentation.** "ISP98 Rule 3.01 (Complying Presentation under a Standby) provides that a standby should indicate the place, the location within that place, and the person to whom presentation should be made. ISP98 Rule 3.04 (Where and to Whom Complying Presentation Made) provides default rules. The indicated place of presentation is significant in determining whether a complying demand is timely presented."[16]

   a. "A standby may require presentation to the issuer to be made at a place that is not the place of issuance, e.g., to and at the address of a processing agent for the issuer (which could be an affiliate or another bank). A standby may also nominate another branch or bank to receive a presentation and act on that nomination. See ISP98 Rule 2.04 (Nomination)"[17]

8. **Time of Presentation.** "ISP98 Rule 3.05 (When Timely Presentation Made) provides that presentation must be made before expiry on the expiration date and that a presentation after business hours is treated as made the next business day. Rule 9.04 (Time of Day of Expiration) provides that expiry occurs at the close of business at the place of presentation."[18]

   a. "Three days to examine and pay a presentation. ISP98 Rules 2.01(c) (Undertaking to Honor by Issuer and Any Confirmer to Beneficiary) and 5.01 (Timely Notice of Dishonor) provide for the time an issuer has to honor or dishonor and include a safe-harbor of three business days after presentation. The three day period begins on the business day following the business day of presentation." The

standard is a reasonable time period ("Notice of dishonor must be given within a time after presentation of documents which is not unreasonable." More than seven (7) days is unreasonable. These time periods can be lengthened or shortened.[19]

i. Notice of dishonor must be specific, comprehensive, prompt, by "telecommunication" unless unavailable, and given to the presenter unless the presenter requests otherwise. Failure to timely state a discrepancy basically bars asserting the discrepancy for that draw but not a future draw request. Failure to timely give a notice of dishonor obligates the issuer to pay at maturity. ISP98 Rule 5.

b. "Demand Date. ISP98 Rule 4.16(b)(ii) (Demand for Payment) provides that a demand must contain an issuance date, and ISP98 Rule 4.06 (Date of Documents) provides that its issuance date may not be later than the date of its presentation."[20]

9. **Expiration Date.**

a. If there is **no stated expiration date or other provision that determines its duration**, a letter of credit expires one year after its stated date of issuance or, if none is stated, after the date on which it is issued. UCC Section 5-106(c).

b. A letter of credit that states that it is **perpetual** expires five years after its stated date of issuance, or if none is stated, after the date on which it is issued. UCC Section 5-106)(d).

c. "Standbys **must contain an expiration date** under ISP98 Rule 9.01 (Duration of Standby) . . . the common practice . . .(is) stating a specific calendar date."[21]

d. ISP suggests that "(t)he stated (expiration) date should be set sufficiently after the underlying obligation becomes due to allow for drawing after refusal of an initial drawing. If payment of the underlying obligation may be made outside of the standby, the stated date should be set to allow also for drawing after any possible rescission of an outside payment made by an insolvent payor."[22]

e. Common practice if an "**evergreen**" ISLOC is sought, "is to set a one year expiration date and allow for automatic annual extensions unless the issuer sends or the beneficiary receives advance notice of non-extension. ISP98 Rule 2.06(a) (When an Amendment is Authorized and Binding) makes "automatic amendments", including extensions of the expiration date, effective without further notification or consent, if the automatic amendment is expressly stated in a standby. ISP98 Form 2 (Model Standby Providing for Extension) focuses on annual automatic extension and other alternatives to a single fixed expiration date."[23]

f. "The **expiration date** stated in a standby **is not necessarily the last day** on which a complying presentation may be made under the standby. ISP98 Rules 3.13 (Expiration Date on a Non- Business Day) and 3.14 (Closure on a Business Day and Authorization of Another Reasonable Place for Presentation) extend the expiration date where it falls on a non-business day or on a day the bank is closed for any other reason."

i. ISP Rule 3.13 basically states that if the expiration date is not a business day "where presentation is to be made", presentation is timely if made on the "first following business day."

ii. ISP Rule 3.14 allows for a 30 day extension for presentation if the presentation location is closed, and allows the issuer to change the presentation location to a "reasonable place" if it is anticipated the presentation location will be closed (with a 30 day extension of the expiration date if the location change is made within 30 days of the schedule expiration date and the presentation is late as a result).

10. **Place and Method of Payment**.

    a. "Unless the standby otherwise states, an issuer is not required to pay anyone other than a beneficiary, a nominated person, or an acknowledged assignee of standby proceeds and is not required to pay anywhere other than at the place of presentation. See ISP98 Rule 6 (Transfer, Assignment, and Transfer by Operation of Law)." [24]

    b. "Payment may be made at the place of presentation by sending a bank check to the order of the beneficiary or by initiating a wire transfer."[25]

    c. Payment by check or wire may be specified in the ISLOC.[26]

11. **Fraud**.

    a. Issuer is discharged to the extent of its performance under the letter of credit unless the issuer honored a presentation in which a required signature of a beneficiary was forged. UCC Section 5-108(5). This essentially means that the beneficiary can still make a demand and be paid, even if the issuer has already paid, if the beneficiary is not the party who requested the draw. Why would the issuer pay a party that is not the beneficiary since the ISLOC is not transferable unless specifically allowed in the ISLOC, and the procedure for transfer is specifically detailed in the ISLOC (see ISP Model Form 4)? The issuer would then seek payment from the applicant.

    b. An issuer "shall honor" a demand for payment if a draw presentation strictly complies with the ISLOC even if "a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant" if the demand is made by certain parties **that are not the beneficiary** (issuer, nominated person, holder in due course, certain assignees). Otherwise, "(t)he issuer, acting in good faith, may honor or dishonor the presentation . . " UCC Section 5-109(a)

    c. UCC Section 5-109(b) enables a payment under the ISLOC to be "temporarily or permanently" enjoined "(i)f an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant".

d. But, if UCP or ISP are incorporated, issuer is potentially let off the hook to the beneficiary if the demand presentation meets the ISLOC demand requirements. UCP, Article 15; UCP, Article 34; ISP, Rule 1.08(b) and UCP, Article 13(a); UCP, Article 14(a); ISP, Rule 4.01(b). The issuer can further prevent itself from honoring a demand presentation from the true beneficiary if it has already honored an ISLOC that states that the issuer is to honor a presentation "purportedly" signed by the beneficiary.[27]

e. Simple way around this problem, state in the ISLOC all payments are to be wired to a specific account of beneficiary detailed in the ISLOC since any forgery only results in the money going to the beneficiary. Change of the destination account can only be accomplished by an amendment to the ISLOC, and an amendment to an irrevocable ISLOC not stating otherwise are not effective against the beneficiary unless the beneficiary has agreed to it ("After a letter of credit is issued, rights and obligations of a beneficiary, applicant, confirmer, and issuer are not affected by an amendment or cancellation to which that person has not consented except to the extent the letter of credit provides that it is revocable or that the issuer may amend or cancel the letter of credit without that consent"). UCC Section 5-106(b) [28]

f. See **Place and Method of Payment** above.

12. **Pay First, Litigate Later**.[29]

a. Beneficiary has no duty to mitigate damages.[30]

b. Applicant has limited right to enjoin. [31]

c. Beneficiary's warranties if it draws.[32]

d. Beneficiary's obligations under the lease and applicant's rights under the lease as to a draw.

e. Applicant still has claims related to unreasonable liquidated damages; unjust enrichment; exceeds statutory, regulatory or public policy limitations. [33]

(iv) **<u>Guaranty</u>**

(a) Variety of forms for leases. Look at the discussions and forms in Chapters 35 and 36 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), entitled "Lease Guaranties", by Michelle Maratto Itkowitz, Esq., and Jay Itkowitz., Esq., and "Model Lease Guaranty", by Joshua Stein, Esq., respectively. Typically:

1. Guaranty of all Obligations/Absolute Guaranty.

2. Limited Guaranty – (certain) monetary obligations and/or (certain) non-monetary obligations.

a. Fixed rent; fixed rent and certain additional rent; unamortized construction allowance, brokerage commission, free rent; condition of the premises at the end of the term.

b. Full guaranty for a certain time period that ends or changes into a form a partial guaranty afterwards if the tenant performs under the lease.

c. Guaranty with a cap on total monetary obligations.

d. Construction/Improvement completion guaranty.

e. Other possibilities.

f. Concerning guaranty of monetary obligations - guaranty of payment or collection (practically always a guaranty of payment).

3. Good Guy Guaranty. The guarantor is released if it meets the conditions, not the tenant.

a. Variations – from the "classic good guy": guarantor released upon surrender of the premises - to others requiring other conditions to be met in order for the guarantor to be released – e.g., advanced notice, that all rent be paid up to the surrender date, formal surrender in required form, required condition of the premises.

b. Guarantor wants it to be easy to surrender the space and be released. If the tenant is credit worthy, the landlord can have recourse to that tenant under the lease.

c. Does making the surrender harder mean that the purpose of the good guy guaranty is subverted – that it is too hard/impossible to be a "good guy" so the tenant opts to fight the guaranty and remains in the premises without paying rent because it can't surrender them without the guarantor being released. It's supposed to be a release of the guarantor if the premises are surrendered, and not a stealth absolute guaranty.

d. What should the condition of the premises be? Should it matter since the landlord got what it wanted: the premises without the protracted struggle, lost rent, legal expense, and inability to relet? What if the broke tenant is malicious and wrecks the premises before surrendering? What if there are any liens (mechanic's liens) or other encumbrances (filed UCC against improvements – note that improvements affixed to premises' typically become landlord's property)?

e. Guarantor should look out for the pitfalls in the surrender requirement.

f. What if a portion of the premises has been sublet? Guarantor remains fully responsible, even if the portion sublet is a small portion of the premises.

g. Does any advance notice of surrender make the surrender mandatory? What if the tenant recovers and does not surrender – and the landlord hires a broker to lease the space and signs a lease with a new tenant? Is the sending of the notice an anticipatory breach of the lease?

h. Guarantor can protect itself by limiting the guaranteed obligations. For example, to fixed rent plus certain additional rent plus certain non-monetary obligations. Guarantor should be wary of accelerated amounts, non-monetary obligations, and clawbacks.

(b) **Selected Issues**

1. Make sure that the Guarantor is vetted – credit checks authorized in writing by the guarantor, litigation checks, financial review, etc. It can be a person or an entity.

2. Where to put what. Landlord signs the lease along with the tenant, but only the guarantor signs the guaranty.

3. Whoever the guarantor is, make sure that there is consideration (benefit for the guarantor's detriment).
    a. Downstream Guaranty – parent guarantees the obligation of a subsidiary; substantial owner guarantees the obligation of a company it owns or owns a substantial portion of.
    b. Upstream Guaranty – subsidiary guarantees the obligation of a parent.
    c. Cross Stream Guaranty – brother – sister guarantees the obligation of a brother – sister.
    d. Have the guaranty mention the benefit to the guarantor in the recitals as well as contain the typical consideration clause. Mention that the landlord would not sign the lease/lease amendment/other document without the guarantor's guaranty. Date the lease documents the same date to make the link between the documents clear.
    e. If the guaranty is not signed as part of the original lease transaction, specify consideration for that guaranty.
4. Closing Documents
    a. If you are the landlord's counsel, perhaps treat the closing like you are a title company or a bank. Get ID's, signatures acknowledged by a notary, resolutions/consents, attorney opinion, company documents, good standing.
    b. Tenant's counsel should consider a waiver of conflict and contribution agreement (guarantors should still be jointly and severally liable).
5. Do you want to obtain periodic financial reports from the guarantor? If there is a financial standard, what then? Is it a default? Does the tenant have to get a new satisfactory guarantor? Does the tenant have to post more security? Etc.
6. Guaranties typically contain guarantor's agreement that the guaranty applies to the lease no matter what happens to or with respect to the lease (survival clause) – and then contains an exhausting waiver list just to make sure. This is because a surety's consent is necessary for it to be liable under a changed document, and waivers are enforceable.
    a. Just to be sure, if anything of consequence occurs, especially if it is in writing - a lease amendment, for instance - the guarantor's consent to the document, affirmation that the guaranteed lease includes that new document, and ratification of the guaranty and the lease, should be obtained, usually as paragraph appearing at the end of the document – after the execution lines but before any exhibits.
    b. If a novation occurs, guarantor is released. "In a novation, the existing obligation is extinguished by the acceptance of a new promise in satisfaction of the original obligation."[34] So, if you cannot get the guarantor to consent, confirm and ratify, draft the agreement so that it does not supersede, substitute, extinguish, revoke, cancel or terminate the lease, that the agreement is an amendment, and that the lease remains in full force and effect.[35]
7. Landlord concessions to Guarantor.

a. Substitute guarantor in certain circumstances (assignment of lease). Landlord needs to consent to the guarantor. Original guarantor released - completely or prospectively.

b. Notices of tenant's default under the lease, and opportunity to cure that default.

III. **Bankruptcy.**

(i) Preliminaries.

(a) When the tenant files a petition for bankruptcy under Section 362 of the Bankruptcy Code (Title 11 of the United States Code), the petition acts as an automatic stay. The Landlord should leave the tenant alone until it hires a bankruptcy attorney.

(b) Tenant has the right to assume or reject the commercial lease – tenant must assume or reject the lease within the earlier of one hundred twenty (120) days or "the date of the entry of an order confirming a plan", which time period the court can extend prior to the expiration of the one hundred twenty (120) days for another ninety (90) days (silence means rejection)(further extensions require the landlord's consent).[36]

(c) If the tenant assumes the lease, it must cure pre and post petition defaults, and "provide adequate assurance of future performance under the lease." Shopping center leases have additional requirements.[37]

(d) If the tenant rejects the lease, "(a)lthough the rejection occurs after the bankruptcy petition has been filed, the Bankruptcy Code creates the legal fiction that rejection constitutes a breach of the lease by the debtor-tenant immediately before the commencement of the bankruptcy case. Treating rejection as a prepetition breach gives the landlord's claim for damages the status of a prebankruptcy claim that, to the extent it is unsecured, may receive a distribution from the bankruptcy estate worth only a fraction of the landlord's damage claim."[38]

1. Landlord typically would be allowed to try and recover all damages allowed under state court.

2. **The Cap**. But, Section 502(b)(6) of the Bankruptcy Code states that a landlord's claim for damages cannot exceed "(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates is capped." In other words, "(i)f Landlord's damages do not exceed one year's rent . . . bankruptcy law will typically allow Landlord to file a claim for the entire amount of Landlord's damages. If, however, Landlord's damages exceed that level . . . Landlord's claim arising from Tenant's breach of the lease will be capped at whichever of these two alternatives is lower: (1) 15% of the remaining rent under the lease or (2) three years' rent. Landlord can also include in its claim any unpaid rent due before Tenant filed."[39]

3. And, "(a)fter the . . . Cap shrinks Landlord's claim, Landlord then joins the throng of unsecured creditors who typically receive pennies on the dollar for their claims. Landlord potentially suffers four times: first, if the lease defines or limits Landlord's damages; second, if state law further limits Landlord's claim; third, if the . . . Cap then

further diminishes Landlord's claim; and fourth, if Landlord, with its diminished claim, becomes an unsecured creditor and might get paid only partially, just like any other unsecured creditor."[40]

a. The security is used to reduce the capped claim **and** the claim allowed by state law. If the actual damages claim is more than the damages allowed by the Cap, the security is applied to reduce them both, not just the larger state damages claim.

(ii) Cases do seem to stand for three principles:

1. Whenever Landlord retains a cash security deposit, the bankruptcy courts will first apply the Claim Cap against Landlord's claim, then credit the cash security deposit against Landlord's remaining claim.

2. Courts will treat L/Cs as security deposits when Tenants give Issuer cash security. The presence of an actual cash deposit (even in Issuer's hands) makes the whole arrangement too much like a cash security deposit to treat it as anything else.

3. If the lease shows the parties intended to use an L/C in place of a cash security deposit, this increases the likelihood a court will apply the Claim Cap. Any suggestion that the L/C replaces or substitutes for a cash security deposit will raise a red flag.[41]

(iii) **Cash**.

(a) The stay prevents the landlord from initially taking it.

(b) The Cap limits what the landlord can recover no matter how large the cash security deposit, and the security deposit reduces the claim as reduced by the Cap even if that claim is less than the statutory claim.

(c) Even if you state the security is liquidated damages, courts won't enforce a penalty.

(iv) **Guaranty**.

(a) A landlord is not barred from pursuing a claim for the full amount of damages allowable under state law against a guarantor of the lease. The stay does not apply to the guarantor and the guarantor "does not receive the benefit of any discharge granted to the debtor-tenant." Essentially, the guarantor's recovery rights against the tenant are subject to the Cap, not the landlord's recovery rights against the guarantor under the guaranty (the guarantor's rights are limited to reimbursement (to the extent that the landlord can recover damages from the tenant under bankruptcy) or subrogation (guarantor obtaining the rights of landlord to the extent that the landlord can recover from the tenant).[42] This makes sense as the purpose of the guaranty should be to get around the Cap risk by shifting it to the guarantor. Guarantees have their own drawbacks, as the landlord has to pursue a third party whose creditworthiness may change and navigate what may be a costly and time consuming process involving at least two (2) documents.

(b) Be wary of substantive consolidation of the guarantor and the tenant. This is an equitable doctrine in bankruptcy that allows for the consolidation of affiliated entities. The consolidation of an entity with a positive net worth with an entity that has a negative net worth can reduce a creditor of the positive net worth entity's recovery since the overall result could change the positive net worth debtor to a negative one, and drag the non-bankrupt creditor into bankruptcy. Can this happen to tenant and the guarantor?[43]

(c) Smart practice – to avoid the time consuming and costly process of seeking to recover against the guarantor in state court only to have the guarantor file a motion in bankruptcy court to extend the stay to the guarantor (this having to incur the time and expense for both), "file a motion in bankruptcy court seeking a declaration that the stay does not apply to the guarantor in order to allow an action on the guaranty to proceed in state court uninhibited."[44]

(d) Court can extend the stay to the guarantor. Landlord can seek relief from the stay.[45]

(v) **Letter of Credit**.

(a) Independence principle should mean that an ISLOC draw is not drawing tenant's cash security but an issuer's money.

(b) Does posting a letter of credit allow the landlord to recover the full amount of the ISLOC to the extent that it is applied against all damages the landlord claims it has suffered (like a guaranty), or is the amount of the ISLOC applied to the damages as reduced by the Cap (like cash security) even if the total damages exceed the Cap?

1. Cases show that the courts seek to make the ISLOC more like cash security and not like a guaranty, meaning that ISLOC draws reduce the damages reduced by the Cap and not just the amount of uncapped damages. There are cases where the courts see no distinction between cash security and proceeds from an ISLOC (especially where the lease states that the ISLOC is in lieu of a cash security deposit). There are cases where the court makes a more nuanced analysis and finds the deposit of cash security by the tenant with the issuer to secure the ISLOC the determining factor.[46]

(c) Suggestions to address these decisions.[47]

Preparation of this presentation was impossible without reviewing, relying heavily on, taking from, applying and using the following materials. These materials often repeated the same points. I urge the reader to consult these materials in any attempt to apply the foregoing materials, and humbly ask that I be excused from any claim or charge of not giving all of the authors proper attribution. They are, in no particular order, the following:

Chapters 35, 36, 37 and 38 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), entitled "Lease Guaranties", by Michelle Maratto Itkowitz, Esq., and Jay Itkowitz., Esq., "Model Lease Guaranty", by Joshua Stein, Esq., "Legal Issues, Practices, and Practicalities for Letter of Credit in Commercial Leases, with a Sample Letter of Credit and Commentary", by Joshua Stein, Esq., and "An Update on the Bankruptcy Law of Large Letters of Credit for Leases", by Joshua Stein, Esq., respectively.

New York Uniform Commercial Code Article 5.

International Chamber of Commerce International Standby Practices (ISP98)(ICC Publication No. 590).

"Letter of Credit as a Landlord's Protection Against a Tenant's Bankruptcy: Assurance of Payment or False Sense of Security", by Alan N Resnick, *The American Bankruptcy Law Journal*, Vol. 82, October 7, 2008.

"Tenant Letters of Credit: Satisfying the Landlord's Lender", by Gary York and Alex Grigorians, *Real Estate law and Industry Report,* 5 REAL 226, April 3, 2012.

"Guaranties, Good Guy Guaranties and How to Use Them in Lease Negotiations and Litigation", a publication by Itkowitz PLISLOC.

"Standby Letter of Credit Rules and Practices Misunderstood or Little Understood by Applicants and Beneficiaries," by Carter H. Klein, *Uniform Commercial Code Law Journal*, Vol. 40 No. 2, Thomson West January 19, 2008.

"What Lawyers Need to Know About the New UCC Section 5 – Letters of Credit," Copyright 2000 by Practicing Law Institute, Chair Sandra Stern, Commercial Law and Practice, Course Handbook Series, Number A-801.

"Revisiting the 24 Defenses of the Guarantor – 24 Years Later", by Joshua Stein and Elaine Wang, *The Practical Real Estate Lawyer,* January, 2012.

"Elegant & Effective … Letters of Credit in Commercial Loans and Bankruptcy" (Part 1 of 3 through 3 of 3), by Anthony Callobre.

And, the variety of CLE's I have attended/listened to/watched over the years touching on these subjects and whose materials I have retained, reviewed, used and relied on from time to time.

[1] "Standby Letter of Credit Rules and Practices Misunderstood or Little Understood by Applicants and Beneficiaries," by Carter H. Klein, *Uniform Commercial Code Law Journal*, Vol. 40 No. 2, Thomson West January 19, 2008, at 145 - 147.

[2] See, for instance, the detailed list of benefits to beneficiaries, issuers and applicants, that, despite its length, is not exhaustive, detailed at pages 140 – 143 in "Standby Letter of Credit Rules and Practices Misunderstood or Little Understood by Applicants and Beneficiaries," by Carter H. Klein, *Uniform Commercial Code Law Journal*, Vol. 40 No. 2, Thomson West January 19, 2008.

[3] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 24.

[4] Klein, *supra* note 1, *at 129.*

[5] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 25.

[6] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnotes 17 and 18.

[7] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 16.

[8] Klein, *supra* note 1, *at 132.*

[9] *Id. at 134 - 136.*

[10] *Id. at 134 - 136.*

[11] *Id. at 134 - 136.*

[12] *Id. at 134 - 136.*

[13] *Id. at 134 - 136.*

[14] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 22.

[15] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 11.

[16] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 12.

[17] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 12.

[18] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 13.

[19] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 15.

[20] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 21.

[21] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 14.

[22] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 14.

[23] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 14.

[24] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 16.

[25] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 16.

[26] ISP98 Form 1 Model Standby Incorporating Annexed Form of Payment Demand with Statement, Footnote 16.

[27] Klein, *supra* note 1, *at 137.*

[28] *Id. at 139.*

[29] *Id. at 144, citing* Eakin, 875 F.2d 114; In re Sabratek Corp., 257 B.R. 732, 45 Collier Bankr. Cas. 2d (MB) 1223 (Bankr. D. Del. 2000).

[30] UCC Section 5-111(a); Klein, *supra* note 1,at 143 – 144.

[31] UCC Section 5-109(b).

[32] UCC Section 5-110

[33] Klein, *supra* note 1,at 144 - 145.

[34] *American Bank & Trust Co. v. Koplik*, 87 A.D.2d 351 (1st Dept. 1982) at 354, as cited in "Careful Drafting Can Keep Guaranties if Loans are Modified", by Alan M. Christenfeld and Shephard W. Melzer, *The New York Law Journal, Vol. 241, No. 24, February 5, 2009*.

[35] *Id.*, at ____.

[36]Section 365(a) and (d)(4) of the Bankruptcy Code.

[37] Section 365 of the Bankruptcy Code.

[38] "Letter of Credit as a Landlord's Protection Against a Tenant's Bankruptcy: Assurance of Payment or False Sense of Security", by Alan N. Resnick, *The American Bankruptcy Law Journal*, Vol. 82, October 7, 2008, at 498; Section 365(g) of the Bankruptcy Code.

[39] Chapter 38 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), entitled "An Update on the Bankruptcy Law of Large Letters of Credit for Leases", by Joshua Stein, Esq., at 38-3 – 38-4.

[40] *Id. at 38-4.*

[41] *Id. at 38-13.*

[42] Resnick, *supra* note 38, at 500 - 501.

[43] Chapter 36 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), entitled "Model Lease Guaranty", by Joshua Stein, Esq., at 36-5.,

[44] Chapter 35 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), entitled "Lease Guaranties", by Michelle Maratto Itkowitz, Esq., and Jay Itkowitz, Esq., at 35-37 - 35-38.

[45] *Id. at* 35-38 – 35-40.

[46] Resnick, *supra* note 38, generally, and Stein, *supra* note 39, generally.

[47] Chapter 38 of the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), entitled "An Update on the Bankruptcy Law of Large Letters of Credit for Leases", by Joshua Stein, Esq., at 38-14 – 38-22.

Exhibits

Security Deposit – use any of the modern (O4) REBNY forms.

Tenant has deposited with Owner the sum of $_____ as security for the faithful performance and observance by Tenant of the terms, provisions and conditions of this lease. It is agreed that in the event Tenant defaults in respect of any of the terms, provisions and conditions of this lease, including, but not limited to, the payment of rent and additional rent, Owner may use, apply or retain the whole or any part of the security so deposited to the extent required for the payment of any rent and additional rent, or any other sum as to which Tenant is in default, or for any sum which Owner may expend, or may be required to expend, by reason of Tenant's default in respect of any of the terms, covenants and conditions of this lease, including but not limited to, any damages or deficiency in the re-letting of the demised premises, whether such damages or deficiency accrued before or after summary proceedings or other re-entry by Owner. In the event that Tenant shall fully and faithfully comply with all of the terms, provisions, covenants and conditions of this lease, the security shall be returned to Tenant after the date fixed as the end of the lease, and after delivery of entire possession of the demised premises to Owner. In the event of a sale of the land and building or leasing of the building, of which the demised premises form a part, Owner shall have the right to transfer the security to the vendee or lessee, and Owner shall thereupon be released by Tenant from all liability for the return of such security; and Tenant agrees to look to the new Owner solely for the return of said security, and it is agreed that the provisions hereof shall apply to every transfer or assignment made of the security to a new Owner. Tenant further covenants that it will not assign or encumber, or attempt to assign or encumber, the monies deposited herein as security, and that neither Owner nor its successors or assigns shall be bound by any such assignment, encumbrance, attempted assignment or attempted encumbrance.

AND, in the portion of the REBNY form defining default:

if Tenant shall have failed, after five (5) days written notice, to redeposit with Owner any portion of the security deposit hereunder which Owner has applied to the payment of any rent and additional rent due and payable hereunder,

NYC Bar Form – found on the NYC Bar Website

Retail Lease

Tenant has deposited with Landlord, as security for Tenant's compliance with this lease, the Security, in cash. If Tenant defaults in performing any of its obligations under this lease, Landlord may use all or any portion of the Security to cure such breach or for the payment of any other amount due and payable from Tenant to Landlord in accordance with this lease. If Tenant shall, during any twelve (12) month period, twice be in breach of its obligation to pay Rent on the first of the month, Tenant shall promptly after Landlord's request, remit to Landlord an amount equal to _____ [number of] months of the then current amount of the monthly installment of Fixed Rent so that the amount of Security required under this lease shall then be equal to _____ months' of then current Fixed Rent. If Landlord uses all or any part of the Security, Tenant shall, within fifteen (15) days following Landlord's notice, deposit with Landlord an amount sufficient to restore the full amount of the Security. Landlord shall not, unless required by any Laws, pay interest to Tenant on the Security, and if Landlord is required to maintain the Security in an interest bearing account or pay any interest to Tenant, Landlord shall retain the maximum amount of interest permitted under any Laws (which Landlord may withdraw and retain annually or at any other times).

Tenant shall not assign (other than to a permitted assignee of this lease) or encumber the Security, and no prohibited assignment or encumbrance by Tenant of the Security shall bind Landlord. Landlord shall not be required to exhaust its remedies against Tenant or the Security before having recourse to Tenant, any Guarantor, the Security or any other security held by Landlord, or before exercising any right or remedy, and recourse by Landlord to any one of them, or the exercise of any right or remedy, shall not affect Landlord's right to pursue any other right or remedy or Landlord's right to proceed against the others. If there is then no uncured breach, the Security and any accrued and unpaid interest thereon, or any balance, shall be paid or delivered to Tenant promptly after the Expiration Date and Tenant's vacating of the Premises in accordance with this lease. If Landlord's interest in the Real Property is sold or leased, Landlord shall transfer the Security and any accrued and unpaid interest thereon, or any balance, to the new Landlord and, upon such transfer, the assignor shall thereupon be automatically released by Tenant from all liability for the return of the Security or any interest (and Tenant agrees to look solely to the assignee for the return of the Security or any interest).

Office Lease

Tenant has deposited with Landlord, as security for Tenant's compliance with this lease, the Security, in cash or, if requested by Landlord or Tenant, by a standby letter of credit on the terms, and substantially in the form, attached to this lease as Exhibit D, issued by a bank that is a member of the New York Clearing House Association, L.L.C. having its principal office in the City of New York and otherwise acceptable to Landlord (the "Letter of Credit"). If there is a Default, Landlord may use all or any portion of the Security to cure the Default or for the payment of any other amount due and payable from Tenant to Landlord in accordance with this lease. Tenant shall, within 15 days following Landlord's notice, deposit with Landlord in cash or by a Letter of Credit an amount sufficient to restore the full amount of the Security (without giving consideration to any interest accrued on the Security). Landlord shall not, unless required by any Law, pay interest to Tenant on the Security, and if Landlord is required to maintain the Security in an interest bearing account or pay any interest to Tenant, Landlord shall retain the maximum amount of interest permitted under any Law (which Landlord may withdraw and retain annually or at any other times). Tenant shall not assign (other than to a permitted assignee of this lease) or encumber the Security, and no prohibited assignment or encumbrance by Tenant of the Security shall bind Landlord. Landlord shall not be required to exhaust its remedies against Tenant or the Security before having recourse to Tenant, any Guarantor, the Security or any other security held by Landlord, or before exercising any right or remedy, and recourse by Landlord to any one of them, or the exercise of any right or remedy, shall not affect Landlord's right to pursue any other right or remedy or Landlord's right to proceed against the others. If there is then no uncured Default, the Security and any accrued and unpaid interest thereon, or any balance, shall be paid or delivered to Tenant promptly after the Expiration Date and Tenant's vacating of the Premises in accordance with this lease. If Landlord's interest in the Building is sold or leased, Landlord shall transfer the Security and any accrued and unpaid interest thereon, or any balance, to the new Landlord and, upon such transfer, the assignor shall thereupon be automatically released by Tenant from all liability for the return of the Security or any interest (and Tenant agrees to look solely to the assignee for the return of the Security or any interest).

Provisions:

It is the intention of the parties that Tenant shall deposit with Landlord and Landlord shall maintain a sum equal to _____ times the monthly _____ due during the last month of the _____ Lease Year of the Term of this Lease at all times.

In the event that Landlord has made any application of all or any part of the security deposit as per the terms and provisions of this Lease, Tenant shall pay Landlord any sum or sums necessary to maintain a security deposit equal _____.

Landlord agrees to deposit the security in an interest bearing account in a bank located in New York State. To the extent not prohibited by law, Landlord shall be entitled to receive and retain as an administrative expense that portion of the interest received on such account which represents the maximum fee permitted under applicable law, which fee Landlord shall have the right to withdraw from time to time, as Landlord may determine. The balance of the interest shall be added to and held as part of the security under this lease subject to and in accordance with the provisions of the foregoing Article. Landlord shall not be required to credit Tenant with any interest for any period during which Landlord does not receive interest on the security deposited.

I suggest you look at Joshua Stein's Lease Security Deposit Provision in his form lease appearing in the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief).

Letter Of Credit

NYC Bar Retail Lease

Notwithstanding any other provision of this lease to the contrary, Tenant may, at any time except if a Default has occurred, substitute the cash Security with an irrevocable, unconditional, "clean", "evergreen" (i.e. automatic renewal) letter of credit in form and substance acceptable to Landlord, issued by a federally insured bank with a Standard & Poor's credit rating of at least AA, whose office for the presentation of a letter of credit to be drawn upon is in New York City and is reasonably acceptable to Landlord. Tenant shall keep any such letter of credit, including without limitation such amendments or replacements as are necessary to increase the amount of the letter of credit as the amount of the required Security increases and after Landlord has drawn on the letter of credit, in full force and effect for not less than sixty (60) days after the Expiration Date of the Term. Landlord may draw upon the letter of credit in whole or in part and apply the proceeds for the same reasons, and in the same manner, as the cash Security. In addition, Landlord may draw upon the letter of credit if (a) Tenant has not supplied an amendment or replacement at least ninety (90) days prior to (i) the expiry date, if any, or (ii) the date on which the amount of the letter of credit is required to be increased; (b) Landlord asks the letter of credit issuer to confirm the current expiry date and the issuer does not do so within ten (10) days after Landlord's request; (c) Tenant fails to pay any bank charges with respect to any Landlord transfer of the letter of credit; (d) the issuer ceases, or announces that it will cease, to maintain an office in New York City where Landlord may present draw requests; or (e) the letter of credit issuer has a credit rating by Standard & Poor's of less than AA and, within thirty (30) days following Landlord's notification to Tenant that the letter of credit issuer's Standard & Poor's credit rating is less than AA, Tenant has not provided Landlord with a replacement letter of credit from an issuer with a Standard & Poor's credit rating of at least AA. Tenant shall not seek to enjoin, prevent or otherwise interfere with Landlord's draw against the letter of credit. Tenant acknowledges that the only effect of an erroneous draw would be to substitute cash Security for the letter of credit, which would not cause Tenant any legally recognizable damage. The letter of credit shall provide that the letter of credit is freely transferable by Landlord, its successors and assigns, as its beneficiary without payment by Landlord (or any subsequent transferee) of any fee or other consideration for such transfer. If Landlord transfers its interest in the Premises, Tenant shall, at Tenant's expense, within ten (10) days after receipt of Landlord's request, deliver to Landlord or its transferee, an amendment to the letter of credit naming Landlord's transferee as substitute beneficiary of the letter of credit.

NYC Bar Office Lease

After first reviewing the cash security deposit provision

If the Security is by a Letter of Credit, the following provisions of this Section shall apply (in addition to the other provisions of this Article):

(a) If the bank issuing the Letter of Credit shall notify Landlord that the term of the Letter of Credit shall not be renewed, Tenant shall, at least 30 days prior to the

expiration date of the Letter of Credit, replace the Letter of Credit with a new Letter of Credit, having an initial expiration date at least one year from the date of the new Letter of Credit.

(b) If, for any reason other than Landlord's failure to comply with the requirements of the Letter of Credit, the bank issuing the Letter of Credit shall fail or refuse to honor any demand, Tenant shall within 15 days following Landlord's notice to Tenant of such failure or refusal, at Landlord's option, either (i) deposit with Landlord the Security in cash or (ii) replace the Letter of Credit with a new Letter of Credit (having an initial expiration date at least one year from the date of the new Letter of Credit).

(c) If Landlord shall transfer its interest in the Building, Tenant shall, at the request of the transferor or transferee, replace or amend the Letter of Credit within 10 days following such request, so that the transferee is named as the beneficiary. Any transfer fee or charge imposed by the bank issuing the Letter of Credit shall be reimbursed to Landlord (or, at Landlord's option, paid) by Tenant within 15 days following Landlord's request.

(d) If there shall be a Default, in addition to any other right or remedy of Landlord, Landlord shall have the right immediately to draw the full amount of the Letter of Credit and hold the cash as the Security.

Another Form

(a) In lieu of the cash security deposit referred to in _____ of this Lease, Tenant may deliver to Landlord, and shall maintain in effect at all times during the term of this Lease following delivery thereof, a "clean", unconditional, irrevocable and transferable standby letter of credit, in the form reasonably satisfactory to Landlord, in the stated amount of _____ (the "**LC Amount**"), issued by a bank ("**Bank**") reasonably satisfactory to Landlord, which is a member of the Federal New York Clearing House and which has a branch office located in the City of New York at which such letter of credit may be drawn. Such letter of credit shall have an expiration date no earlier than the first anniversary of the date of issuance thereof and shall provide that it shall be automatically renewed from year to year unless terminated by the Bank by notice to Landlord given not less than sixty (60) days prior to the then expiration date thereof by certified or registered mail, return receipt requested. The final expiration date of the letter of credit (including any renewals) shall be no earlier than the thirtieth (30^{th}) day after the Expiration Date. Such letter of credit shall be issued for the account of the Landlord.

(b) If Landlord at any time, or from time to time, requests any reasonable change in the terms, conditions or provisions of such letter of credit (other than the LC Amount), Tenant shall promptly cause such letter of credit to be so modified at Tenant's sole cost and expense. If the letter of credit is lost, mutilated, stolen, or destroyed, Tenant shall cooperate with Landlord's efforts to cause the Bank to cancel the lost, mutilated, stolen or destroyed letter of credit and to replace such letter of credit.

(c) Landlord may draw on such letter of credit, in whole or in part (at Landlord's sole option), if: (i) Tenant defaults with respect of any of the terms, conditions or provisions of this Lease on the Tenant's part to be observed or performed, including but not limited to, the payment of rent or additional rent, and such default continues beyond the applicable grace period, if any, or (ii) Tenant, or anyone holding possession of the demised premises through Tenant, holds over in the demised premises after the expiration or sooner termination of the term of this Lease, or (iii) Landlord is given notice that the Bank is terminating such letter of credit, or (iv) such letter of credit expires as of a stated date by its terms and is not replaced with a

letter of credit meeting the criteria set forth in this Section at least thirty (30) days prior to such letter of credit's stated expiration date.

(d) Landlord may use, apply, or retain the proceeds of the letter of credit to the same extent Landlord may use, apply or retain the security deposit, as set forth in _____ of this Lease. If any of the proceeds of the letter of credit are not applied immediately to cure any default of Tenant, Landlord shall hold such unapplied proceeds as cash security in accordance with the provisions of Art. 34 and Section 5.7 of this lease. If Landlord partially draws down the letter of credit, Tenant shall, within ten (10) days after Landlord gives Tenant notice thereof, cause the amount of the letter of credit to be increased to the LC Amount, or substitute cash security instead. If Tenant fully and faithfully complies with all of the terms, covenants, and provisions of this Lease, any letter of credit, or any remaining portion of any sum collected by Landlord hereunder through a draw on such letter of credit, shall be returned to Tenant within thirty (30) days after the expiration date of this Lease and delivery of possession of the demised premises to Landlord in accordance with the provisions of this Lease.

(e) If the Property and/or Building are sold, or if the entire Building is ground leased or if another person or entity acquires Landlord's interest in this Lease, Landlord may transfer the security, including the letter of credit, to the new owner or lessee. If the security is so transferred, by operation of law or otherwise, Landlord shall thereupon be released by Tenant from all liability for the return of the security, including the letter of credit, and Tenant shall look solely to the new owner or lessee for the return of the security in accordance with the terms of this Lease. The provisions of this subparagraph shall apply to every such transfer or lease. If Landlord desires to transfer the letter of credit to such new owner or lessee, Tenant shall cooperate in effecting such transfer and shall reimburse the Landlord, as additional rent, within ten (10) days after being billed therefor, for any fee paid by Landlord to the Bank in connection with the transfer of such letter of credit.

(f) Tenant shall have the right to substitute one letter of credit for another if the substitute letter of credit meets the requirements of this _____ and is in form satisfactory to Landlord. In addition, Tenant shall substitute another letter of credit meeting the requirements of this_____ for the letter of credit held by Landlord if the Bank which has issued the letter of credit becomes insolvent or if the letter of credit is void, unenforceable, or uncollectible. If the Bank which has issued the letter of credit becomes unacceptable to Landlord, Tenant shall, within fifteen (15) days after notice is given Tenant by Landlord, deliver to Landlord either a substitute letter of credit meeting the requirements of this _____ or cash security, each to be in the LC Amount.

(g) To the extent not prohibited by law, Landlord shall be entitled to receive and retain annually as an administrative expense one percent (1%) of the LC Amount. Tenant shall pay same to Landlord as Additional Rent within thirty (30) days after being billed therefor by Landlord, which bill Landlord shall have the right to send to Tenant from time to time, as Landlord may determine.

I suggest you look at Joshua Stein's Lease Security Deposit Provision in his form lease appearing in the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief), as it contains a Letter of Credit provision. The same Treatise includes a chapter on Letters of Credit with a form.

GOOD GUY" GUARANTY OF LEASE

This Good Guy Guaranty of Lease is dated as of the ____ day of _____, ____ (this "**Guaranty**") and made by _____ a _____ having a having a business address at _____, and _____ a natural person having a residence address at _____, (collectively, "**Guarantor**"**)**, to and in favor of _____, a _____, having a business address at_____ (the "**Landlord**").

RECITALS

A. _____, a _____, with an address at _____ ("**Tenant**") is simultaneously herewith entering into a Lease Agreement (the "**Lease**") with Landlord at certain premises known as _____ at 3_____ (the "**Demised Premises**").

B. As a condition precedent to Landlord entering into the Lease of even date herewith, Landlord has required and Guarantor has agreed that it shall execute and deliver to Landlord this Guaranty.

C. Guarantor is _____ and, as a result, gains a material benefit from the Lease being executed and delivered.

D. All capitalized terms used herein shall have to the meaning ascribed to them in the Lease unless otherwise specifically set forth herein.

AGREEMENT

In consideration of, and as an inducement to, Landlord agreeing to the Lease and for such other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Guarantor agrees as follows:

1. Guarantor guarantees to Landlord (A) the full and immediate payment of all Rent set forth in the Lease, (B) the due and punctual performance of all other obligations of the Tenant under the Lease, and (C) the full and immediate payment of all of Landlord's fees, costs and expenses, including reasonable attorney's fees, of enforcement of this Guaranty against Guarantor. The performance and payment provided for herein shall become immediately due and payable to Landlord upon receipt by Guarantor of Landlord's demand therefor. Any payment by any Guarantor hereunder shall be made within five (5) calendar days after written demand for such payment is made by Landlord. If any Guarantor fails to make payment of any amount required to be paid by such Guarantor under this Guaranty when payment is due, interest shall accrue on the amount of the payment from and after the due date until payment is paid to Landlord at the lesser of (1) 20.00% per annum, or (2) the maximum amount permitted under applicable law.

2. Guarantor acknowledges and agrees that its liability hereunder shall be primary and that in any right of action which shall accrue to Landlord under the Lease, Landlord may, at its option, proceed against Guarantor and Tenant, jointly and severally, or against Guarantor under this Guaranty without commencing any suit or proceeding of any kind or nature whatsoever against Tenant or obtaining any judgment against Tenant. Guarantor hereby waives any notices other than the notices required under the Lease, diligence, presentment, demand of payment, notice of non-payment, notice of dishonor, protest, non-performance or non-observance, notice of acceptance of this Guaranty, filing of claims with a court in the event the merger or bankruptcy of Tenant, any right to require a proceeding first against Tenant or to realize on any collateral, protest, notice and all demands whatsoever, with respect to any of the obligations guaranteed hereunder by Guarantor.

3. Guarantor agrees that this Guaranty constitutes a guaranty of payment and not of collection and Guarantor's obligations are not in any way conditional or contingent upon any attempt to collect from or enforce against Tenant or upon any other condition or contingency. Guarantor furthermore acknowledges that Landlord's, and, subject to required consent of Landlord, Tenant's interest in the Lease may be transferred in whole or in part without affecting the validity or enforceability of this Guaranty and that the benefit of Guarantor's obligations hereunder shall extend to each successor and assign of Landlord automatically and without notice to Guarantor. The covenants under this Guaranty will not be discharged except by complete performance of the obligations contained in the Lease and this Guaranty.

4. Guarantor expressly agrees that this Guaranty shall be a continuing, absolute, unconditional guaranty with full recourse to Guarantor and not subject to any reduction, limitation, impairment, termination, defense, set-off, counterclaim or recoupment whatsoever. The validity of this Guaranty and the obligations and liability of Guarantor hereunder shall in no way be terminated, affected, modified, diminished or impaired by reason of (a) the assertion of the failure by Landlord to assert against Tenant any of the rights or remedies reserved to Landlord pursuant to the Lease, (b) any bankruptcy, insolvency, reorganization, dissolution, arrangement, assignment for the benefit of creditors, receivership or trusteeship affecting the Tenant or its successors or assigns under the Lease or of any other guarantor of the Lease or any surety, whether or not notice thereof is given to Guarantor, (c) the genuineness, validity, regularity or enforceability of the Lease, (d) any rescission, compromise, alteration, amendment, restatement, modification, extension, expiration, termination, renewal, release, change, waiver, consent or other action in respect of any of the terms, provisions, covenants or conditions contained in the Lease or any agreement, instrument or document securing the Lease, with or without notice to or assent from Guarantor, (e) the absence of notice or the absence of or any delay in action to enforce any obligation or to exercise any right or remedy against Tenant, or the Guarantor, or any other guarantor or surety, whether under the Lease or any agreement, instrument or document securing the Lease or under any other agreement instrument or document, or any indulgence, extension or waiver granted to or compromise with Tenant or the Guarantor, or any other guarantor or surety, (f) any assumption by any person or entity of any obligation under the Lease or any agreement, instrument or document securing the Lease, (g) any event of force majeure, (h) any release or substitution of any security or collateral for the Guaranty obligations or obligations under any guaranty, bond or other agreement, instrument or document, in whole or in part, with or without notice to or assent from Tenant or the Guarantor, (i) any extension of time, consent, indulgence, waiver or other action, inaction or omission under or concerning the Lease, (j) any dealings or transactions or matter or thing occurring between Landlord and Tenant, or (k) any other circumstance or condition that may grant or result in a discharge, limitation or reduction of liability of a surety or guarantor.

5. No delay on the part of Landlord in exercising any right, power or privilege under this Guaranty nor any failure to exercise the same shall operate as a waiver of or otherwise affect any right, power or privilege, nor shall any single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any other right, power or privilege.

6. Guarantor shall at any time from time to time, within five (5) days following request by Landlord, execute, acknowledge and deliver to Landlord a statement certifying that this Guaranty is unmodified and in full force and effect (or if there have been modifications, that the same is in full force and effect as modified and stating such modifications).

7. As a further inducement to Landlord to deliver the Lease and in consideration thereof, Guarantor covenants and agrees that in any action or proceeding brought on, under or by virtue of this Guaranty, Guarantor shall and hereby does waive trial by jury.

8. If, by reason of (a) the operation of any bankruptcy, insolvency, reorganization, arrangement, assignment for the benefit of creditors, receivership, trusteeship or other law for the relief of debtors, now or hereafter enacted, or (b) any judgment, decree or order of any court or administrative body having

jurisdiction over Tenant or Guarantor or any of their property, pursuant to or in connection with any such laws, any payment or performance or property received by Landlord on account of any obligation under the Lease or this Guaranty is required to be transferred, refunded or paid over to any party other than Landlord, or if Landlord should settle any claim with respect thereto, then, in such event, Guarantor agrees to pay Landlord the amount so required (or agreed in settlement) to be refunded, transferred, or paid over by Landlord and the obligations of the Guarantor under this Guaranty shall not be treated as having been discharged by reason of the payment or performance so refunded, transferred or paid over and Guarantor shall also be and remain liable to Landlord hereunder for any amounts not on account of the obligations guaranteed hereby. Landlord shall not be required to litigate or otherwise dispute its obligation to make such refund, transfer or payment if, in good faith and on the advice of counsel, it believes that such obligation exists. If Tenant becomes insolvent or shall be adjudicated a bankrupt or shall file for reorganization or similar relief or if such petition is filed by creditors of Tenant, under any present or future federal or state law or if the Lease is terminated or Tenant's obligations otherwise discharged in any bankruptcy proceeding, Guarantor's obligations hereunder may nevertheless be enforced against the Guarantor.

9. No waiver or modification of any provision of this Guaranty nor any termination of this Guaranty shall be effective unless in writing and signed by the party against which the waiver, modification or termination is sought to be enforced, nor shall any waiver be applicable except in the specific instance for which it is given.

10. The validity and enforcement of this Guaranty shall be governed by and construed in accordance with the internal laws of the State of New York without regard to principles of conflicts of law. Guarantor hereby irrevocably submits to the jurisdiction of any federal or state court sitting in the county in which the Demised Premises is located over any action or proceeding arising out of or related to this Guaranty and agrees that personal jurisdiction over Guarantor rests with such courts for purposes of any action on or related to this Guaranty. Guarantor agrees that a final judgment in any such action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any manner provided by law. Guarantor further waives any objection to venue in any such action or proceeding on the basis of inconvenient forum. Guarantor agrees that any action on or proceeding brought against Landlord shall only be brought in such courts.

11. All notices, demands, requests, consents, approvals or other communications (collectively, "**Notices**") desired or required to be given under this Guaranty shall be in writing, and, any law or statute to the contrary notwithstanding, shall be effective for any purpose if given or served by hand or by prepaid certified or registered mail return receipt requested, addressed as follows:

If to Guarantor, to the Demised Premises with a copy to _____.

If to Landlord, to the Notice address set forth in the Lease.

All notices shall be deemed given or served on the day delivered, if hand delivered, or three (3) business days after being deposited in the United States mail, if mailed. Either party may change the address to which Notices shall be delivered by notice in accordance with this Paragraph.

12. This Guaranty shall be binding upon and inure to the benefit of Guarantor and Landlord and their respective heirs, successors and permitted assigns. Guarantor shall not assign its rights or obligations or delegate its duties under this Guaranty.

13. Any indebtedness or obligation of Tenant to Guarantor is hereby expressly subordinated as to priority of lien, time of payment and in all other respects to all sums at any time owing to Landlord under the Lease and Guarantor shall not be entitled to enforce or receive payment on account of such other indebtedness until all sums owing to Landlord have been paid. Any sums so received by Guarantor shall be held in trust for and paid over to Landlord.

14. All remedies afforded to Landlord by reason of this Guaranty are separate and cumulative remedies and it is agreed that no one remedy, whether exercised by Landlord or not shall be deemed to be in exclusion of any other remedy available to Landlord and shall not limit or prejudice any other legal or equitable remedy which Landlord may have.

15. If any provision of this Guaranty or the application thereof to any person or circumstance shall to any extent be held void, unenforceable or invalid, the remainder of this Guaranty and the application of such provision to persons or circumstances other than those as to which it is held void, unenforceable or invalid, shall not be affected thereby and each provision of this Guaranty shall be valid and enforceable to the fullest extent permitted by law.

16. If two or more individuals, corporations, partnerships or other business associations (or any combination of two or more thereof) shall sign this Guaranty as Guarantor, the liability of each such individual, corporation, partnership or other business association to pay any moneys and/or perform any and all other obligations hereunder shall be deemed to be joint and several and all notices, payments and agreements given or made by, with or to any one of such individuals, corporations, partnerships or other business associations shall be deemed to have been given or made by, with or to all of them. In like manner, if Guarantor shall be a partnership or other business association, the members of which are, by virtue of statute or federal law, subject to personal liability, the liability of each such member shall be joint and several.

17. Any security deposit under the Lease shall not be credited against amounts payable by Tenant or by Guarantor under the terms of this Guarantee. The acceptance by Landlord of payments under this Guarantee or the acceptance of a surrender of the Demised Premises shall not be deemed a release or waiver by Landlord of any obligation of the Tenant under the Lease.

18. Notwithstanding anything set forth in this "Good Guy" Guaranty of Lease to the contrary, the obligations of Guarantor under (A) and (B) of paragraph 1 of this "Good Guy" Guaranty of Lease shall terminate on the ninetieth (90^{th}) day after Tenant and Guarantor have Notified Landlord that Tenant is surrendering the Premises to Landlord (the "**Ninetieth Day**")(the purpose of such Notice being to allow the Guarantor to be released of its prospective obligations under (A) and (B) of paragraph 1 of this "Good Guy" Guaranty of Lease and not to release the Tenant of any its obligations under the Lease), provided (i) Tenant has surrendered and delivered vacant possession of the Premises to Landlord in the condition required by the Lease on the Expiration Date by the Ninetieth Day, which surrender and delivery shall include an original surrender agreement which has been signed by Tenant, is in a form reasonably acceptable to Landlord, and has been delivered to Landlord, and (ii) all Rent has been paid to Landlord up to and including the Ninetieth Day.

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Another good guy provision

Guarantor guarantees to Landlord (A) the full and immediate payment of all Rent set forth in the Lease (but not by acceleration) up to and including either (i) the date Tenant has surrendered and delivered vacant possession of the Demised Premises to Landlord, but only if (x) Tenant has given no less than ninety (90), and no more than one hundred (100), days advance notice to Landlord of its intent to so surrender and vacate, (y) Tenant in fact vacates and surrenders the Demised Premises to Landlord between such ninetieth (90^{th}) and one hundredth (100th) day inclusive, and (z) Tenant has paid in full all Rent then due and owing under the Lease through such vacating and surrender date, or (ii) if Tenant has not provided such advance notice and/or has not so timely surrendered and vacated and/or Tenant has not so timely paid Rent in full, the date which is ninety (90) days following the date that Tenant has (xx) surrendered and delivered vacant possession of the Demised Premises to Landlord, and (yy) paid in full all Rent (aa) then due and owing under the Lease, and (bb) due and owing under the Lease for the ninety (90) day period occurring after such up-to-date Rent payment, vacating and surrender, (B) that Tenant shall deliver possession of the Demised Premises to Landlord in vacant, broom clean condition absent any repairs made necessary as a result of Tenant's removing any of its personal property therefrom, and (C) the full and immediate payment of all of Landlord's fees, costs and expenses, including reasonable attorney's fees, of enforcement of this Guaranty against Guarantor.

Using Josh Stein's Form

"GOOD GUY" GUARANTY OF LEASE

This **GUARANTY** (the "**Guaranty**") is made as of _____, 2018 (the "**Guaranty Date**") by _____, a natural person, whose address is _____, (with its successors and assigns, "**Guarantor**"), for the benefit of , a _____ whose address is _____ (with its successors and assigns, "**Landlord**"). Guarantor signs and delivers this Guaranty based on these facts:

I. Landlord is about to enter into _____ (as further defined below, the "**Lease**") with _____, a _____ (with its successors and assigns, "**Tenant**"), dated on or about the Guaranty Date.

II. The Lease initially demises premises designated as _____ (as modified from time to time in accordance with the Lease or by agreement between Landlord and Tenant, the "**Premises**").

III. Guarantor is the principal of Tenant.

IV. The Lease will therefore benefit Guarantor.

V. Landlord would not enter into the Lease unless Guarantor signed this Guaranty.

NOW, THEREFORE, in exchange for $100 and other valuable consideration, receipt of which Guarantor acknowledges, and to induce Landlord to enter into the Lease, Guarantor agrees:

A. Definitions. Any term defined in the Lease has the same meaning in this Guaranty, except as expressly modified or superseded here. This Guaranty also uses these terms:

1. "**90^{th} Day**" means the ninetieth (90^{th}) day occurring after the date the Tenant has delivered an Advance Termination Notice to Landlord.

2. "**Advance Termination Notice**" means a written notice from Tenant to Landlord stating Tenant's intention to deliver vacant possession of the entire Premises to Landlord in the condition the Lease requires at the end of the Term by the 90th Day.

3. "**Guarantied Obligations**" means all liabilities and obligations of Tenant under the Lease, in each case whether or not Tenant's notice or cure period, if any, has ended. If a Guarantied Obligation arises only after notice to Tenant but Landlord cannot legally give notice to Tenant, then Landlord may at its option instead notify Guarantor. The Guarantied Obligation shall then be determined, for this Guaranty, as if Landlord had notified Tenant. If the Lease gives Tenant a right to contract, expand, extend or renew, or to acquire the Premises or an interest in Landlord, then the "Guarantied Obligations" include Tenant's obligations from an exercise of that right, whether or not Guarantor consents. The Guarantied Obligations also include all obligations of Tenant to Landlord relating to the Premises and arising under landlord-tenant law, such as liability for holdover rent, damages, use and occupancy payments and rent for month-to-month occupancy after the Lease ends.

4. "**Insolvency Law**" means Title 11, United States Code, or other or successor state or federal statute on assignment for benefit of creditors, appointment of a receiver or bankruptcy, composition, insolvency, moratorium, reorganization, trustee appointment or similar matters.

5. "**Insolvency Proceeding**" means any proceeding (or appointment), voluntary or involuntary, under Insolvency Law.

6. "**Landlord Remedy(ies)**" means Landlord's rights and remedies under the Lease or law, including Insolvency Law, including any right to terminate the Lease, evict Tenant, collect damages for default and apply or not apply any security deposit or letter of credit Tenant delivered.

7. "**Lease**" means: (a) the Lease, as initially defined above, as amended, assigned, extended or renewed from time to time, whether or not with Guarantor's consent; and (b) Tenant's obligations to Landlord under Law regarding the Premises, including after the Lease as defined above expires, terminates or otherwise ends. The "**Lease**" shall be defined without regard to any: (i) Insolvency Proceeding; (ii) resulting limitation, modification, reinstatement, rejection or termination of the Lease or Tenant's obligations; or (iii) exercise of Landlord Remedies.

8. "**Legal Costs**" means Landlord's actual reasonable costs of collection and legal representation for any actual or threatened: (a) Tenant default under any Guarantied Obligation; (b) Guarantor default or Landlord claim under this Guaranty; or (c) Proceeding. Those costs include reasonable attorneys' fees, disbursements and other charges billed by Landlord's attorneys, court costs and costs of process servers, private investigators and all other personnel whose services are charged to Landlord in connection with Landlord's receipt of legal services. Legal Costs also include all other costs of collection.

9. "**Proceeding**" means any action, arbitration, counterclaim, litigation or other proceeding on, arising out of or relating to interpretation or enforcement of this Guaranty or the Lease, including a Tenant or Guarantor Insolvency Proceeding and any exercise of Landlord Remedies.

10. "**Tenant**" means: (a) Tenant as defined above; (b) any estate created through a Tenant Insolvency Proceeding; (c) any liquidator, receiver or trustee of Tenant or any of its property; (d) any similar person or officer, appointed in any Insolvency Proceeding or otherwise and (e) any heir, successor or assign of Tenant.

11. "**Tenant Occupant**" means Tenant and any person occupying or claiming any Premises by or through Tenant.

12. "**Termination Conditions**" means the following conditions: (a) all Tenant Occupants have vacated the Premises and Tenant has delivered vacant possession of the entire Premises to Landlord in the condition the Lease requires; (b) reserved; (c) all Tenant Occupants have surrendered

the Lease under surrender documentation in form and substance reasonably satisfactory to Landlord; (d) Tenant has performed all its Lease obligations arising from any construction Tenant initiated; and (e) all Rent accrued under the Lease to date has been paid, and all other obligations of Tenant accrued to date under the Lease (excluding any obligations calculated in whole or in part by any reference to obligations accruing or arising after the Termination Date) have been paid or performed.

13. "**Termination Date**" means the later of (i) provided Tenant has satisfied the Termination Conditions as of such date, the 90th Day, or (ii) if Tenant fails to provide the Advance Termination Notice or fails to surrender the Premises by the 90th Day or Tenant has not satisfied the Termination Conditions as of the 90th Day, the date ninety (90) days after the date when Tenant has satisfied the Termination Conditions so long as all Rent due under the Lease has been paid through that ninetieth (90) day.

B. Guaranty of Guarantied Obligations. Guarantor absolutely, irrevocably and unconditionally guarantees Tenant's timely payment and performance of all Guarantied Obligations through the Termination Date. Guarantor covenants that Tenant will pay and perform all Guarantied Obligations when and as the Lease requires. If Tenant does not do that, then Guarantor shall. For any Guarantied Obligation, Guarantor shall pay all damages and losses that Landlord suffers and the Lease or Law entitles Landlord to recover, including Landlord's Legal Costs, because Tenant fails timely to pay or perform. Guarantor's liability under this Guaranty is primary, not secondary, in the full amount of the Guarantied Obligations, including interest, default interest, late fees and costs and fees (including Legal Costs) relating to the Guarantied Obligations. Any unpaid Guarantied Obligation shall bear interest from the date it accrues until the date paid, both before and after entry of judgment, at the higher of: (a) the interest rate that applies after Default under the Lease; or (b) the judgment rate. If Landlord obtains a judgment against Tenant for any Guarantied Obligation,

GUARANTY OF LEASE

This **GUARANTY OF LEASE** is dated as of the ____ day of _____ (this "**Guaranty**") and made by _____, a _____ organized and existing under the laws of the State of _____, with a business address at _____ _____ (each or collectively, "**Guarantor**"**)**, to and in favor of _____, a _____ duly organized and existing under the laws of the State of New York, with a business address _____ ("**Landlord**").

RECITALS

A. _____, a _____ organized and existing under the laws of the State of _____ with a place of business at_____ ("**Tenant**") is simultaneously herewith entering into an Office Lease Agreement (the "**Lease**") with Landlord for certain premises more specifically set forth in such lease and located in the building known as _____ (the "**Demised Premises**").

B. As a condition precedent to Landlord entering into the Lease of even date herewith, Landlord has required and Guarantor has agreed that it shall execute and deliver this Guaranty to Landlord.

C. Guarantor is the sole owner/are the sole owners of the Equity Interests in the Tenant and, as a result, gains/gain a material benefit from the Lease being executed and delivered.

AGREEMENT

In consideration of, and as an inducement to, Landlord agreeing to the Lease and for such other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Guarantor agrees as follows:

Section 1. Definitions. As used in this Guaranty, the following terms have the following meanings (terms defined in the singular to have the same meaning when used in the plural and vice versa):

"**Governmental Authority**" means any nation or national government including the federal government of the United States of America, any state or state government, any municipality or municipal government, any entity exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government, any other subdivision, council, department, branch or agency of any of the foregoing and any court, judge, administrator or tribunal exercising judicial or administrative functions.

"Guaranteed Obligations" means (a) any and all present and future liabilities, duties and obligations of Tenant to Landlord under any and all of the terms of the Lease, including (i) the full and immediate payment of all Rent and all other charges set forth in the Lease, and (ii) the due and punctual performance of all other obligations of the Tenant under the Lease, and (b) all Losses.

"**Laws**" means any present or future domestic or foreign, national, federal, state, provincial, local or municipal statute, law, rule, regulation, ordinance, order, code, decree, policy, requirement or rule of common law, now or hereafter in effect, in each case as amended, and any judicial or administrative interpretation thereof by a Governmental Authority or otherwise, including any judicial or administrative order, decree (including a consent decree or consent order), judgment or agreement with a Governmental Authority, and all permits, licenses, approvals and authorizations issued by a Governmental Authority, and including parking, zoning, building, subdivision and land use Laws.

"**Losses**" means any and all losses, damages, liability, costs and expenses incurred by Landlord in respect of or as a result of any or all claims, suits, liabilities (including strict liabilities), actions, demands, proceedings, enforcements, obligations, debts, damages (including punitive and consequential), fines, trials, penalties, charges, diminution of value, injury to a person, property or natural resources, fees (including attorney's fees and all fees of any experts and other costs of defense or prosecutions or otherwise related thereto), judgments, accounts, orders, adjudications, awards, liens, injunctive relief, causes of action or amounts paid in settlement of whatever kind or nature arising out of the Lease or this Guaranty.

"**Material Adverse Change"** means either (1) a material adverse change in the status of a Person's assets, liabilities, financial condition or property or (2) any event or occurrence of whatever nature which does or is reasonably likely to have a material adverse effect on the ability of a Person to perform such Person's obligations.

"**Person**" means an individual, partnership (including a limited liability partnership and a general partnership), corporation, limited liability company, business trust, joint stock company, trust, unincorporated association, joint venture, Governmental Authority or other entity of whatever nature whatsoever, including Landlord.

Unless otherwise specified in this Guaranty, terms defined in the Lease which are used in this Guaranty will have the same meaning when used in this Guaranty. Guarantor acknowledges that Guarantor has received a copy of this Guaranty and the Lease.

Section 2. Rules of Interpretation.
When used in this Guaranty: (1) "or" is not exclusive, (2) any pronouns used shall include the corresponding masculine, feminine or neuter form, (3) the singular form of nouns and pronouns shall include the plural and vice versa and terms defined in the singular have the same meaning when used in the plural and vice versa, (4) a reference to a Law includes any present or future amendment or modification to such Law, (5) a reference to an agreement, instrument or document includes any present or future amendment or modification of such agreement, instrument or document, to the extent and provided that such amendment or modification is permitted by such agreement, instrument or document and is permitted under the Lease, and (6) the word "including" means "including, but not limited to,".

Section 3. Guaranty.

(a) Guarantor hereby guarantees to Landlord and its successors, transferees and assigns the prompt and complete performance or payment, as the case may be, as and when due, of (1) all of the Guaranteed Obligations now existing or hereafter incurred or arising, and (2) all fees, costs and expenses of enforcement of this Guaranty against Guarantor. Guarantor hereby guarantees that the Guaranteed Obligations will be paid or performed, as the case may be, strictly in accordance with their terms.

(b) Guarantor acknowledges that, notwithstanding any other provision of this Guaranty or of the Lease to the contrary, the obligations of Guarantor under this Guaranty are irrevocable, unlimited, joint and several personal obligations of each and every Guarantor. Guarantor acknowledges that Landlord would not make the Lease but for the personal liability undertaken hereunder by Guarantor.

(c) The obligation of Guarantor under this Guaranty shall be limited to an aggregate amount equal to the largest amount that would not render the obligation of Guarantor under this Guaranty subject to avoidance under Section 548 of the United States Bankruptcy Code or any comparable provision of any applicable Law.

Section 4. Payments/Performance.

(a) Any payment by any Guarantor hereunder shall be made within five (5) calendar days after written demand for such payment is made by Landlord. If any Guarantor fails to make payment of any amount required to be paid by such Guarantor under this Guaranty when payment is due, interest shall accrue on the amount of the payment from and after the due date until payment is paid to Landlord at the lesser of (1) 20.00% per annum, or (2) the maximum amount permitted under applicable Law.

(b) All payments provided for hereunder shall be made to Landlord at its offices in accordance with Section 15, below, entitled "Notices", in lawful money of the United States of America, in immediately available funds, and without defense, reservation, setoff or counterclaim of any nature.

(c) The performance provided for herein shall become immediately due to Landlord upon receipt by Guarantor of Landlord's demand therefor.

Section 5. Type of Guaranty/Continuity of Guaranty/Reinstatement of Guaranty.

(a) This Guaranty is absolute and unconditional and as such is not subject to any conditions and Guarantor is fully liable to perform all of its duties and obligations under this Guaranty as of the date of execution of this Guaranty. This Guaranty is a continuing guaranty and applies to all future Guaranteed Obligations. In addition, this Guaranty shall remain in full force and effect even if at any time there are no outstanding Guaranteed Obligations. This Guaranty is a guaranty of payment and not of collection. The obligations and liabilities of Guarantor under this Guaranty shall not be conditioned or contingent upon the pursuit by Landlord of any other right or remedy, including (a) a right or remedy against (i) Tenant or any other Person (including any Guarantor) which may be or become liable in respect of all or any part of the Guaranteed Obligations, or (ii) any assets (including any Security) securing the payment of the Guaranteed Obligations, (b) any other guarantee for such Guaranteed Obligations, or (c) any right of setoff with respect to such Guaranteed Obligations.

(b) This Guaranty shall continue to be effective or shall be reinstated, as the case may be, if at any time any payment or performance, as the case may be, or any part thereof, of any of the Guaranteed Obligations are rescinded or must otherwise be returned by Landlord for any reason, including upon the insolvency, bankruptcy, dissolution, liquidation or reorganization of Guarantor or Tenant, all as though such payment had not been made. If, by reason of (a) the operation of any bankruptcy, insolvency, reorganization, arrangement, assignment for the benefit of creditors, receivership, trusteeship or other Laws for the relief of debtors, now or hereafter enacted, or (b) any judgment, decree or order of any court or administrative body having jurisdiction over Tenant or Guarantor or any of their property, pursuant to or in connection with any such Laws, any payment or performance or property received by Landlord on account of any obligation under the Lease or this Guaranty is required to be transferred, refunded or paid over to any party other than Landlord, or if Landlord should settle any claim with respect thereto, then, in such event, Guarantor agrees to pay Landlord the amount so required (or agreed in settlement) to be refunded, transferred, or paid over by Landlord and the obligations of the Guarantor under this Guaranty shall not be treated as having been discharged by reason of the payment or performance so refunded, transferred or paid over and Guarantor shall also be and remain liable to Landlord hereunder for any amounts not on account of the obligations guaranteed hereby. Landlord shall not be required to litigate or otherwise dispute its obligation to make such refund, transfer or payment if, in good faith and on the advice of counsel, it believes that such obligation exists.

(c) Guarantor hereby consents that, without the necessity of any reservation of rights against Guarantor and without notice to or further assent by Guarantor, any demand for payment or performance of any of the Guaranteed Obligations made by Landlord may be rescinded at any time by Landlord and any and all of such Guaranteed Obligations shall continue after such rescission.

(d) Guarantor acknowledges and agrees that its liability hereunder shall be primary and that in any right of action which shall accrue to Landlord under the Lease, Landlord may, at its option, proceed against Guarantor and Tenant, jointly and severally, or against Guarantor under this Guaranty without commencing any suit or proceeding of any kind or nature whatsoever against Tenant or obtaining any judgment against Tenant. Guarantor hereby waives any notices other than the notices required under the Lease, diligence, presentment, demand of payment, notice of non-payment, notice of dishonor, protest, non-performance or non-observance, notice of acceptance of this Guaranty, filing of claims with a court in the event the merger or bankruptcy of Tenant, any right to require a proceeding first against Tenant or to realize on any collateral, protest, notice and all demands whatsoever, with respect to any of the obligations guaranteed hereunder by Guarantor.

(e) Guarantor expressly agrees that this Guaranty shall be a continuing, absolute, unconditional guaranty with full recourse to Guarantor and not subject to any reduction, limitation, impairment, termination, defense, set-off, counterclaim or recoupment whatsoever, unless specifically required under Section 3(c).

Section 6. Survival.
Notwithstanding anything to the contrary contained in this Guaranty or in the Lease, this Guaranty shall continue in full force and effect after the termination of the Lease as the result of an Event of Default or the exercise by Landlord of any of the remedies available under the Lease, at Law, in equity or otherwise, with respect to any of the Guaranteed Obligations, whether incurred prior to or subsequent to such termination. **WITHOUT IN ANY WAY LIMITING THE ABOVE, IT IS EXPRESSLY UNDERSTOOD THAT GUARANTOR'S DUTY(IES) AND OBLIGATIONS HEREUNDER TO LANDLORD SHALL SURVIVE ANY JUDICIAL OR NONJUDICIAL TERMINATION OF THE LEASE.**

Section 7. Representations.
Guarantor represents and warrants to Landlord as follows:

7.1. **No Contravention.** The execution, delivery and performance by Guarantor of this Guaranty do not and will not (a) violate any provision of any Law, order, writ, judgment, injunction, decree, determination, or award presently in effect applicable to Guarantor, (b) result in a breach of or constitute a default under any indenture or loan or credit agreement or any other agreement, lease, or instrument to which Guarantor is a party or by which Guarantor or its properties may be bound or affected, or (c) result in, or require, the creation or imposition of any lien upon or with respect to any of the properties now owned or hereafter acquired by Guarantor.

7.2 **Governmental Authority.** No authorization, approval or other action by, and no notice to or filing with, any Governmental Authority is required for the due execution, delivery and performance by Guarantor of this Guaranty.

7.3 **Legally Enforceable Guaranty.** This Guaranty is the legal, valid and binding obligation of Guarantor, enforceable against Guarantor in accordance with its terms, except to the extent that such enforcement may be limited by (a) applicable bankruptcy or insolvency of Guarantor, and other similar Laws affecting creditors' rights generally, or (b) general equitable principles, regardless of whether the issue of enforceability is considered in a proceeding in equity or at Law. The validity of this Guaranty and the obligations and liability of Guarantor hereunder shall in no way be terminated, affected, modified, diminished or impaired by reason of, without limitation, (a) the assertion of the failure by Landlord to assert against Tenant any of the rights or remedies reserved to Landlord pursuant to the Lease, (b) any bankruptcy, insolvency, reorganization, dissolution, arrangement, assignment for the benefit of creditors, receivership or trusteeship affecting the Tenant or its successors or assigns under the Lease or of any other guarantor of the Lease or any surety, whether or not notice thereof is given to Guarantor, (c) the genuineness, validity, regularity or enforceability of the Lease, (d) any rescission, compromise, alteration, amendment, restatement, modification, extension, expiration, termination, renewal, release, change, waiver, consent or other action in respect of any of the terms, provisions, covenants or conditions contained in the Lease or any agreement, instrument or document securing the Lease, with or without notice to or assent from Guarantor, (e) the absence of notice or the absence of or any delay in action to enforce any obligation or to exercise any right or remedy against Tenant, or the Guarantor, or any other guarantor or surety, whether under the Lease or any agreement, instrument or document securing the Lease or under any other agreement instrument or document, or any indulgence, extension or waiver granted to or compromise with Tenant or

the Guarantor, or any other guarantor or surety, (f) any assumption by any person of any obligation under the Lease or any agreement, instrument or document securing the Lease, (g) any event of Force Majeure, (h) any release or substitution of any security or collateral for the Guaranty obligations or obligations under any guaranty, bond or other agreement, instrument or document, in whole or in part, with or without notice to or assent from Tenant or the Guarantor, (i) any extension of time, consent, indulgence, waiver or other action, inaction or omission under or concerning the Lease, (j) any dealings or transactions or matter or thing occurring between Landlord and Tenant, or (k) any other circumstance or condition that may grant or result in a discharge, limitation or reduction of liability of a surety or guarantor.

Section 8. Waiver of Notices.
Guarantor hereby waives any and all notices including (1) notice of or proof of reliance by Landlord upon this Guaranty or acceptance of this Guaranty, (2) notice of the incurrence of any Guaranteed Obligations or any modification thereof, including any renewal, extension, modification, consolidation, advance, increase, assumption, subordination, participation, assignment or accrual of any Guaranteed Obligations, (3) notice of any actions taken by Landlord or Tenant or any other Person under the Lease, and (4) notices of Default, Event of Default or nonperformance.

Section 9. Waiver of Defenses.
(a) Guarantor hereby waives any and all defenses to the performance by Guarantor of its duties and obligations under this Guaranty, including any defense based on any of the following:

9.1 any failure of Landlord to disclose to Guarantor any information relating to the business, condition (financial or otherwise), operations, performance, properties or prospects of any party obligated under the Lease, whether as principal, guarantor or indemnitor, now or hereafter known to Landlord, including any information relating to Tenant, the Demised Premises or any other circumstances bearing on Tenant's ability to perform the Guaranteed Obligations,

9.2 any defense to the payment or performance of any or all the Guaranteed Obligations, including illegality, lack of validity or enforceability of any of the Guaranteed Obligations or the Lease,

9.3 any change in the time, manner or place of payment of, or in any other term in respect of, all or any of the Guaranteed Obligations, or any other amendment or waiver of or consent to any departure from or any modification to the Lease,

9.4 any exchange or release of, or non-perfection of any security interest on or in, any assets, including the Security, securing the payment or performance of the Guaranteed Obligations,

9.5 any failure to execute any other guaranty for all or any part of the Guaranteed Obligations, or any release, amendment or waiver of, or consent to any departure from, any other guaranty for any or all of the Guaranteed Obligations, or the release of any obligor in respect of the Guaranteed Obligations,

9.6 any act or omission of Landlord in connection with the enforcement of, or the exercise of rights and remedies, including any election of, or the order of exercising, any remedies with respect to (a) the Guaranteed Obligations, including the assertion of the failure by Landlord to assert against Tenant any of the rights or remedies reserved to Landlord pursuant to the Lease, (b) any other guarantor of all or any part of the Guaranteed Obligations, or (c) any assets, including the Security, securing the payment or performance of the Guaranteed Obligations,

9.7 any failure to give or provide any notices, demands or protests of any kind including those specified under "Waiver of Notices" (Section 8),

9.8 the defense of the statute of limitation in any action under this Guaranty or for the collection or the performance of the Guaranteed Obligations,

9.9 any subordination of any or all of the Guaranteed Obligations,

9.10 any manner of application of any funds received by Landlord to the Guaranteed Obligations or any other obligations owed to Landlord, whether from the sale or disposition of any assets securing the Guaranteed Obligations, from another guarantor of the Guaranteed Obligations, or otherwise,

9.11 any defense that may arise by reason of (a) the incapacity, lack of authority, death or disability of any Guarantor, or any other Person, (b) the revocation or repudiation of this Guaranty by any Guarantor, or the revocation or repudiation of the Lease by any other Person, or (c) the failure of Landlord to file or enforce a claim against the estate (either in administration, bankruptcy or any other proceeding) of any Guarantor or any other Person,

9.12 any sale or transfer of all or any part of the Project;

9.13 all homestead exemption rights against the obligations under this Guaranty;

9.14 any statute or rule of Law which provides that the obligation of a surety must be neither larger in amount nor in any other respects more burdensome than that of a principal;

9.15 Landlord's election, in any proceeding instituted under the Federal Bankruptcy Code, of the application of Section 1111(b)(2) of the Federal Bankruptcy Code or any successor statute;

9.16 any borrowing or any grant of a security interest under Section 364 of the Federal Bankruptcy Code; and

9.17 any right of subrogation, any right to enforce any remedy which Landlord may have against Tenant, and any right to participate in, or benefit from, any security for the Lease now or hereafter held by Landlord.

(b) Guarantor further waives any and all rights and defenses that any Guarantor may have because the Guaranteed Obligations may be wholly or partially secured; this means, among other things, that: (1) Landlord may collect from any Guarantor without first crediting any Security provided by Tenant; (2) if Landlord first credits any Security provided by Tenant, then (A) the amount of the monetary portion of the Guaranteed Obligations may be reduced only by the amount of any Security provided by Tenant (but only if Tenant is not obligated to replenish the same), and (B) Landlord may collect from any Guarantor even if Landlord, by utilizing any Security provided by Tenant, has destroyed or limited any right any Guarantor may have to collect from Tenant. The foregoing sentence is an unconditional and irrevocable waiver of any rights and defenses that any Guarantor may have because the Guaranteed Obligations are secured by any Security provided by Tenant. These rights and defenses being waived by Guarantor include, but are not limited to, any rights or defenses based upon subrogation, reimbursement, indemnification and contribution. In addition, Guarantor agrees that the performance of any act or any payment which tolls any statute of limitations applicable to the Lease shall similarly operate to toll the statute of limitations applicable to the Guarantor's liability hereunder. Guarantor understands that Guarantor's duties,

obligations and liabilities under this Guaranty are not limited in any way by any information (whether obtained from Tenant, from any Guarantor, or from Landlord's own investigations) which Landlord may have concerning the Demised Premises.

(c) Guarantor waives any right to, and agrees not to, assert a counterclaim, other than a mandatory or compulsory counterclaim (unless Landlord agrees in writing not to assert such waiver, in which event Tenant may assert any such claim in a separate action), in any action or proceeding brought against or by Landlord. Tenant acknowledges this right gives Tenant an adequate remedy.

(d) Guarantor hereby acknowledges that: (a) the obligations undertaken by Guarantor in this Guaranty are complex in nature, and (b) numerous possible defenses to the enforceability of these obligations may presently exist or may arise hereafter, and (c) as part of Landlord's consideration for entering into this transaction, Landlord has specifically bargained for the waiver and relinquishment by Guarantor of all such defenses, and (d) Guarantor has had the opportunity to seek and receive legal advice from skilled legal counsel in the area of transactions of the type contemplated herein. Given all of the above, Guarantor does hereby represent and confirm to Landlord that Guarantor is fully informed regarding, and that Guarantor does thoroughly understand: (i) the nature of all such possible defenses, and (ii) the circumstances under which such defenses may arise, and (iii) the benefits which such defenses might confer upon Guarantor, and (iv) the legal consequences to Guarantor of waiving such defenses. Guarantor acknowledges that it makes this Guaranty with the intent that this Guaranty and all of the informed waivers herein shall each and all be fully enforceable by Landlord, and that Landlord is induced to enter into this transaction in material reliance upon the presumed full enforceability thereof.

Section 10. Subrogation.
Guarantor may not exercise any rights which Guarantor may acquire by way of subrogation or contribution, whether acquired by any payment or performance made under this Guaranty, by any setoff or application of funds of Tenant by Landlord, or otherwise, until (1) the payment or performance and other satisfaction in full of the Guaranteed Obligations, and (2) the payment of all fees and expenses to be paid by Guarantor pursuant to this Guaranty. If any amount shall be paid to Guarantor on account of such subrogation or contribution rights at any time when all of the Guaranteed Obligations and all such other expenses shall not have been paid in full, such amount shall be held in trust for the benefit of Landlord, shall be segregated from the other funds of Guarantor, and shall forthwith be paid over to Landlord to be credited and applied in whole or in part by Landlord against the Guaranteed Obligations, whether matured or unmatured, and all such other costs, fees, charges, expenses or other amounts due under and in accordance with the terms of the Lease.

Section 11. Reporting Requirements.
Guarantor will provide immediate notice to Landlord if (1) any representation and warranty included in this Guaranty would no longer be true if made on such date, or (2) there is a Material Adverse Change regarding Guarantor. Guarantor shall furnish to Landlord from time to time such information regarding Guarantor as Landlord may reasonably request including any documentation or reports relating to any Guarantor which Tenant is required to furnish to Landlord under the Lease.

Section 12. Remedies.
Landlord shall not, by any act, delay, omission or otherwise, be deemed to have waived any of its rights or remedies under this Guaranty or otherwise. A waiver by Landlord of any right or remedy hereunder on any one occasion, shall not be construed as a ban or waiver of any such right or remedy which Landlord would have had on any future occasion, nor shall Landlord be liable for exercising or failing to exercise any such

right or remedy. The rights and remedies of Landlord under this Guaranty are cumulative and, as such, are in addition to any other rights and remedies available to Landlord under Law or any other agreements.

Section 13. Indemnity and Expenses.
Guarantor hereby indemnifies Landlord from and against any and all claims, Losses, damages and liabilities growing out of, in connection with, arising under or resulting from this Guaranty (including enforcement of this Guaranty), except claims, losses, damages or liabilities solely resulting from Landlord's gross negligence and willful misconduct. The obligations of Guarantor under this Guaranty shall specifically include, without limitation, the obligation to expend Guarantor's own funds, to incur costs in Guarantor's own name(s) and to perform all actions as may be necessary to protect the Landlord from the necessity of expending Landlord's own funds, incurring costs or performing any actions in connection with the matters for which Landlord is entitled to collect or to be paid or be reimbursed pursuant to this Guaranty, and, if Landlord nonetheless expends its own funds or incurs any such cost or expense, to immediately pay or reimburse Landlord therefor.

Section 14. Amendments.
No amendment or waiver of any provision of this Guaranty, nor consent to any departure by Guarantor from this Guaranty, shall in any event be effective unless the same shall be in writing and signed by the party against whom enforcement thereof is sought, and then such amendment or waiver shall be effective only in the specific instance and for the specific purpose for which given.

Section 15. Notices.
Notice to any party shall be made in writing, and shall be served by (a) personal delivery to the recipient, (b) reserved, (c) United States Postal Service-certified mail-return receipt requested (postage prepaid) or (d) reliable overnight public express mail service that keeps a record of its deliveries (for next business day delivery), and sent to the addresses set forth below:

If to Guarantor: _____.

If to Landlord: _____.

or such other address as may hereafter be furnished to the other party by like notice. Any such notice shall be deemed to have been given (a), if by personal delivery, on the day of delivery, (b), if sent via United States Postal Service, on the fifth (5^{th}) day following posting of same with a United States Post Office and (c), if sent by overnight public express mail, on the next business day.

Section 16. Assignment and Transfer of Obligations.
This Guaranty will bind the estate of Guarantor as to all Guaranteed Obligations in existence, created or incurred both before and after the death or incapacity of Guarantor, whether or not Landlord receives notice of such death or incapacity. This Guaranty shall inure to the benefit of Landlord and its successors, transferees and assigns. Guarantor may not transfer or assign its obligations under this Guaranty. Landlord may assign or otherwise transfer all or a portion of its rights or obligations with respect to the Guaranteed Obligations to any other party to whom the Lease is transferred, and such other party shall then become vested with all the benefits in respect of such transferred Guaranteed Obligations granted to Landlord in this Guaranty or otherwise. Guarantor agrees that Landlord can provide information regarding Guarantor to any prospective or actual successor, transferee or assign.

Section 17. Remedies.

All remedies afforded to Landlord by reason of this Guaranty are separate and cumulative remedies and it is agreed that no one remedy, whether exercised by Landlord or not shall be deemed to be in exclusion of any other remedy available to Landlord and shall not limit or prejudice any other legal or equitable remedy which Landlord may have.

Section 18. Submission to Jurisdiction.
Guarantor hereby irrevocably submits to the jurisdiction of any federal or state court sitting in the county in which the Demised Premises is located over any action or proceeding arising out of or related to this Guaranty and agrees with Landlord that personal jurisdiction over Guarantor rests with such courts for purposes of any action on or related to this Guaranty. Guarantor hereby waives personal service by manual delivery or in-hand delivery and agrees that service of process may be made by means of notice given in accordance with Section 15 of this Guaranty, and that upon the giving of such notice in accordance with Section 15 hereof, such service will be effective as if such Guarantor was personally served. Guarantor agrees that a final judgment in any such action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any manner provided by Law. Guarantor further waives any objection to venue in any such action or proceeding on the basis of inconvenient forum. Guarantor agrees that any action on or proceeding brought against Landlord shall only be brought in such courts.

Section 19. Governing Law.
This Guaranty shall be governed by and construed in accordance with the Laws of the State in which the Demised Premises is located.

Section 20. Subordination.
Guarantor will not until the Expiration Date and the complete satisfaction of all Guaranteed Obligations (1) make any demand for payment of, or take any action to accelerate, any obligation owed to Guarantor by Tenant, (2) seek to collect payment of, or enforce any right or remedies against Tenant, any of the obligations owed to Guarantor by Tenant or any guarantees, credit supports, collateral or other security related to or supporting any of such obligations, or (3) commence, or join with any other creditor in commencing, any bankruptcy or similar proceeding against Tenant. Guarantor also agrees that the payment of all obligations of Tenant to Guarantor shall be subordinate and junior in time and right of payment in accordance with the terms of this Section to the prior full satisfaction of the Guaranteed Obligations. In furtherance of such subordination, (1) to the extent possible, Guarantor will not take or receive from Tenant any payments, in cash or any other property, by setoff or any other means, of any or all of the obligations owed to Guarantor by Tenant, or purchase, redeem, or otherwise acquire any of such obligations, or change the terms or provisions of any such obligations, and (2) if for any reason and under any circumstance Guarantor receives a payment on such obligation, whether in a bankruptcy or similar proceeding or otherwise, all such payments or distributions upon or with respect to such obligations shall be received in trust for the benefit of Landlord, shall be segregated from other funds and property held by Guarantor and shall be forthwith paid over to Landlord in the same form as so received (with any necessary endorsement) to be applied (in the case of cash) to, or held as collateral (in the case of securities or other non-cash property) for, the payment or prepayment of the Guaranteed Obligations.

Section 21. Miscellaneous.
This Guaranty is in addition to and not in limitation of any other rights and remedies Landlord may have by virtue of any other instrument or agreement previously, contemporaneously or hereafter executed by Guarantor or any other party or by Law or otherwise. If any provision of this Guaranty is contrary to applicable Law, such provision shall be deemed ineffective without invalidating the remaining provisions of this Guaranty. Titles in this Guaranty are for convenience of reference only and shall not affect the interpretation or construction of this Guaranty. This Guaranty constitutes the entire agreement between

Guarantor and Landlord with respect to the matters covered by this Guaranty and supercedes all written or oral agreements with respect to such matters.

Guarantor has taken all necessary action to authorize the execution, delivery and performance of this Guaranty and has the power and authority to execute, deliver and perform this Guaranty. The person signing this Guaranty on behalf of Guarantor is authorized to do so. This Guaranty and all obligations of Guarantor hereunder are the legal, valid and binding obligations of Guarantor, enforceable in accordance with the terms of this Guaranty, except as such enforcement may be limited by bankruptcy, insolvency, reorganization or other similar laws affecting the enforcement of creditors' rights generally and by general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

The execution and delivery of this Guaranty the performance of its obligations hereunder by Guarantor will not conflict with any provision of any law or regulation to which Guarantor is subject or any agreement or instrument to which Guarantor is a party or by which it is bound or any order or decree applicable to Guarantor or result in the creation or imposition of any lien on any of Guarantor's assets or property which would adversely affect the ability of Guarantor to carry out the terms of this Guaranty. Guarantor has obtained any consent, approval, authorization or order of any court or governmental agency or body required for the execution, delivery or performance by Guarantor of this Guaranty.

Guarantor is not a, and is not acting directly or indirectly for or on behalf of any, person, group, entity or nation named by any Executive Order of the United States Treasury Department as a terrorist, "Specifically Designated National and Blocked Persons," or other banned or blocked person, entity, nation or transaction pursuant to any law, order, rule or regulation that is enforced or administered by the Office of Foreign Assets Control and Guarantor is not engaged in this transaction, directly or indirectly on behalf of, or instigating or facilitating this transaction, directly or indirectly, on behalf of any such person, group, entity, or nation.

Guarantor specifically acknowledges the provisions of the Lease concerning Transfers, including Exempt Transfers, Assignments to a Successor of Tenant, and subleases to Related Entities, and agrees that it shall fully cooperate with Landlord in connection with any and all such Transfers.

Any Security under the Lease shall not be credited against amounts payable by Tenant or by Guarantor under the terms of this Guaranty. The acceptance by Landlord of payments under this Guaranty or the acceptance of a surrender of the Demised Premises shall not be deemed a release or waiver by Landlord of any obligation of the Tenant under the Lease.

Section 22. Further Assurances.
At any time and from time to time, upon Landlord's prior written request, Guarantor shall make, execute and deliver, or cause to be made, executed and delivered, to Landlord in order to effectuate, or to continue and preserve the obligations of such Guarantor under this Guaranty, such documents or instruments as Landlord may request.

Section 23. Duplicate Originals.
This Guaranty may be executed in any number of duplicate originals and each duplicate original shall be deemed to be an original. The failure of any party hereto to execute this Guaranty, or any counterpart hereof, shall not relieve the other signatories from their obligations hereunder. A copy of this Guaranty bearing a facsimile or photocopied signature or a signature transmitted by email, scan or other digital or electronic means shall have the same force and effect as one with an original ink signature of the Guarantor.

Section 24. WAIVER OF TRIAL BY JURY.
GUARANTOR AND LANDLORD (A) AGREE NOT TO ELECT A TRIAL BY JURY WITH RESPECT TO ANY ISSUE ARISING OUT OF THIS GUARANTY THAT IS TRIABLE OF RIGHT BY A JURY AND (B) WAIVE ANY RIGHT TO TRIAL BY JURY WITH RESPECT TO ANY SUCH ISSUE TO THE EXTENT THAT ANY SUCH RIGHT EXISTS NOW OR IN THE FUTURE. THIS WAIVER OF RIGHT TO TRIAL BY JURY IS SEPARATELY GIVEN BY EACH PARTY, KNOWINGLY AND VOLUNTARILY WITH THE BENEFIT OF COMPETENT LEGAL COUNSEL.

Section 25. Reserved.

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Execution Page Follows

I suggest you look at Joshua Stein's Article and Form of Guaranty and Article Relating to the same appearing in the Third Edition of the New York State Bar Association's Commercial Leasing Treatise, Copyright 2017 (Joshua Stein, Esq., Editor in Chief).

LC Forms ISP98 from Website

ISP98 Model Forms*

1 – Model Standby Incorporating Annexed Form of Payment Demand with Statement

2 – Model Standby Providing for Extension and Incorporating Annexed Form of Payment Demand with Alternative Non-Extension Statement

3 – Model Standby Providing for Reduction and Incorporating Annexed Form of Reduction Demand

4 – Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand

5 - Simplified Demand Only Standby

6 – Model Counter Standby with Annexed Form of Local Bank Undertaking

7 – Model Standby Requiring Confirmation

8 – Model Confirmation of Standby

11.1 – Model Government Standby Form

These forms are published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

The Model Forms are subject to revision according to developments in standby practice. The date of the most recent revision of each Model Form is noted in its title and text.

ISP98 Form 1
Model Standby Incorporating Annexed Form of Payment Demand with Statement*

[name and address of beneficiary] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]** ("Applicant"),[1] we **[name and address of issuer at place of issuance]** ("Issuer") issue [2] this irrevocable[3] standby letter of credit number **[reference number]** ("Standby")[4] in favour of **[name and address of beneficiary]** ("Beneficiary")[5] in the maximum aggregate amount[6] of **[currency/amount]**.

Undertaking. Issuer undertakes to Beneficiary[7] to pay[8] Beneficiary's demand for payment in the currency and for an amount available under this Standby[9] and in the form of the Annexed Payment Demand completed as indicated[10] and presented[11] to Issuer at the following place for presentation: **[address of place for presentation]**,[12] on or before the expiration date.[13]

Expiration. The expiration date of this Standby is **[date]**.[14]

[*Payment. Payment against a complying presentation shall be made within 3 business days*[15] *after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary. An advice of such payment shall be sent to Beneficiary's above-stated address.*][16]

[*Drawing. Partial and multiple drawings are permitted.*][17]

[*Reduction. Any payment made under this Standby shall reduce the amount available under it.*][18]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).[19]

[*Communications. Communications other than demands may be made to Issuer by telephone, telefax, or SWIFT message, to the following:* ***[numbers/addresses]****. Beneficiary requests for amendment of this Standby, including amendment to reflect a change in Beneficiary's address, should be made to Applicant, who may then request Issuer to issue the desired amendment.*][20]

[**Issuer's name]**

[signature]
Authorized Signature

Annexed Payment Demand

[INSERT DATE][21]

[name and address of Issuer or other addressee at place of presentation as stated in standby][22]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby")[23]

The undersigned Beneficiary demands payment of [INSERT CURRENCY/AMOUNT] under the Standby.[24]

Beneficiary states[25] that Applicant[26] is obligated[27] to pay to Beneficiary the amount demanded[, *which amount is due and unpaid*[28]] under[*or in connection with*] the agreement[29] between Beneficiary and Applicant[30] titled **[agreement title]** and dated **[date]**.

[*Beneficiary further states that the proceeds*[31] *from this demand will be used to satisfy*[32] *the above-identified obligations and that Beneficiary will account to Applicant*[33] *for any proceeds that are not so used*.]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].[34]

[Beneficiary's name and address][35]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE][36]
[INSERT TYPED/PRINTED NAME AND TITLE]

[Before the standby is issued, all text in **[bold]** should be completed, and optional text in [*italics*] should be included or deleted (or redrafted). Text in the annexed demand form preceded by "INSERT" (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the beneficiary prepares and presents a demand.]

****

This ISP98 Form 1 model standby includes terms that ISP98 indicates should be included in a standby. It includes terms that restate other ISP98 rules for the avoidance of doubt, e.g., that the standby is irrevocable and permits partial demands. It uses words, phrases, and spellings that are

used in ISP98. It also includes optional terms that are specific about when and how payment will be made.

This ISP98 Form 1 incorporates an annexed model form of payment demand that includes terms that ISP98 indicates should be included when making a presentation. This demand form also includes beneficiary statements of a type the applicant or beneficiary may desire in order to identify the underlying obligation(s) to be supported by the standby (and to be satisfied upon honour of the standby).

The annexed demand form may also be used as a precedent by a beneficiary preparing a demand to be presented under an ISP98 standby that does not specify the entire form of demand to be presented. See ISP98 Form 5 (Simplified Demand Only Standby).

This ISP98 Form 1 is intended to be self-contained and, absent special circumstances, useable without extended reference to the text of ISP98.

The endnotes to this form include alternative and other optional terms, as well as references to relevant ISP98 rules. Other ISP98 model standby forms vary this form, e.g., by adding text and annexes (with relevant endnotes) that focus on expiration, reduction, transfer, confirmation, and counter standby support.

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Applicant. As noted in ISP98 Rule 1.09(a) (Definitions), the "applicant" is the person who applies for issuance or for whose account the standby is issued. Typically, the applicant stated in the standby is the person whose underlying obligation is supported by the standby. The standby's terms should be appropriate to support those underlying obligations, and the underlying documentation should appropriately provide for the standby and for the use of funds paid under the standby.

Where a standby is issued on the application of a correspondent bank from whom the issuer expects reimbursement, consideration should be given to an alternative clause: "At the request and for the account of **[name of correspondent bank]**, ("Applicant") acting at the request and for the account of its customer, **[XYZ]**...". Similarly, where a standby is issued on the application of a parent company, consideration should be given to an alternative clause: "At the request and for the account of **[Parent]** ("Applicant") acting at the request and for the account of its subsidiary **[name]**…".

This standby form adds "("Applicant")" after the name of the applicant, and that defined term is used in the annexed model demand form. If this parenthetical definition (or the parenthetical definition for the issuer or the beneficiary) is not wanted, appropriate adjustments should be made in the standby, including in any statement required to be included with any beneficiary demand. If an adjustment is made because the applicant is not also the underlying obligor (or the beneficiary is not also the underlying obligee), then the adjustments should be made in the standby and also in the documentation underlying the standby. See endnote 30.

Except for endnotes 1 and 30, these endnotes do not address issues that may arise where the applicant is not the underlying obligor or where there are multiple applicants.

[2] Issuance. The name of the issuer and the place(s) of issuance and presentation should be indicated in the standby. The indicated place of issuance is significant in determining what law governs the issuer's obligations. Absent an indication of the place of issuance in the standby, it may prove difficult to determine a single place of issuance, even with full knowledge of the process resulting in sending the standby to the beneficiary. This form, including endnotes, does not address the possibility, briefly addressed in ISP98 Rule 10 (Syndication/Participation), of multiple issuers or of participating interests in a single issuer's standby facility.

Rule 2.03 (Conditions to Issuance) provides generally that a standby is issued when it leaves the issuer's control, and Rule 3.05 (When Timely Presentation Made) allows presentation any time after issuance (and before expiry) It is customary for a standby to recite the issuance date either at the top of the undertaking or in the first paragraph of the text (or both).

[3] Irrevocability. It is unnecessary to state that an ISP98 standby is irrevocable. See ISP98 Rule 1.06(a) and (b) (Nature of Standbys). However, because of the contrary rule in UCP82 (1933) until UCP500 (1993), some letter of credit users expect or require inclusion of the word "irrevocable".

[4] Name of undertaking. While this form of undertaking is named a "standby letter of credit", the name is not determinative of its character as an undertaking within the scope of ISP98 or as an independent undertaking under applicable law. As provided in ISP98 Rule 1.01(b) (Scope and Application), it could be called an independent guarantee, bank guarantee, bond, or any other name.

[5] Beneficiary. The beneficiary named in a standby is the person to whom the issuer's obligation is owed. Typically, there is one named beneficiary of the issuer's undertaking, who is also the obligee of the applicant's obligation that is supported by the standby. This standby form, including endnotes, does not address issues that may arise where the named beneficiary is not the underlying obligee or where there are multiple beneficiaries.

[6] Amount available. A standby should expressly state the amount available under the standby. Standbys commonly add that the stated amount of a standby is the "maximum" (or "full" or "not

to exceed") "aggregate" amount. These are unnecessary additions because ISP98 Rule 3.08 (Partial Drawings & Multiple Presentations; Amount of Drawings) permits presentations for less, but not more, than the amount available under a standby.

Under ISP98 Rule 3.08(e) (Partial Drawings & Multiple Presentations; Amount of Drawings), a drawing that exceeds the amount available under the standby is discrepant. To override that rule and require the issuer to pay the full amount available under the standby against a presentation that would comply but for the "credit overdrawn" discrepancy, the following clause may be added: "If a demand exceeds the amount available, but the presentation otherwise complies, Issuer undertakes to pay the amount available."

[7] Undertaking to the beneficiary only. It is unnecessary to state that an issuer's payment obligation is made "to Beneficiary". Except as otherwise stated in the standby or mandated by applicable law, a standby that names a beneficiary and does not identify any other person as having rights under the standby obligates the issuer solely to the named beneficiary. ISP98 Rule 2.04 (Nomination) provides for the possibility that a standby nominates another person to confirm the issuer's undertaking or otherwise to give value against the named beneficiary's complying demand. ISP98 Rule 6 (Transfer, Assignment, and Transfer by Operation of Law) provides for the possibility that an issuer is requested to acknowledge a person claiming to be a transferee beneficiary or an assignee of standby proceeds or a successor beneficiary. ISP98 Form 4 (Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand) focuses on transfer of drawing rights by beneficiary demand and other standby terms affecting a claimed transferee beneficiary, assignee of standby proceeds, or successor beneficiary.

[8] Honour by payment. An issuer may undertake to honour a letter of credit other than by sight payment. Under ISP98 Rule 2.01 (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) an issuer may undertake to honour by non-recourse negotiation (purchase) of the documents presented or by acceptance of a time draft or incurrence of a deferred payment undertaking, followed by payment at maturity. Also, an issuer may undertake to honour by the delivery of an item of value, such as gold, in which case the issuer must be able to deliver the specified item. These other forms of honour are not covered in this form because they are much less common for standbys than honour by sight payment.

[9] Presentation of standby. An issuer's obligation is not dependant on the beneficiary's holding or presenting the standby, unless the standby so provides. See ISP98 Rule 2.03 (Conditions to Issuance). This form, like most standbys, does not require presentation of the standby with a payment demand. Any such requirement exposes the beneficiary to the risk that a demand may be rightfully refused if the standby is lost or otherwise cannot be timely presented. It also exposes the issuer to disputes over the issuer's receipt, handling, or return of the standby. There are other ways to avoid payment against a forged demand, e.g., by providing in the standby that payment must be made to a specified beneficiary account.

Under ISP98 Rule 3.12 (Original Standby Lost, Stolen, Mutilated, or Destroyed), an issuer is entitled to enforce a requirement that the standby be presented with a demand. However, the rule also gives an issuer considerable discretion to excuse or remedy a beneficiary's failure to present the standby. If greater certainty is desired, then the standby could add the following or a variation: "Issuer undertakes to exercise its discretion under ISP98 Rule 3.12 to waive the requirement to present this Standby (or to replace it) against Beneficiary's representations and indemnities (including third party indemnities deemed appropriate by Issuer) in favor of Issuer and Applicant that are reasonably satisfactory to Issuer." The representations and indemnities should run to the applicant as well as the issuer. Although the issuer would determine what is reasonable at the time of taking any representations or indemnities, the applicant would bear the ultimate risk of payment against a forged demand.

The term "this Standby" in this ISP98 Form 1, like the term "original standby" in ISP98 Rule 3.12 (and Rule 6.03 (Conditions to Transfer)), refers to the originally signed/authenticated undertaking that evidences the issuer's obligation. Unless the issuer sends a signed/authenticated undertaking directly to the beneficiary, it may be desirable to clarify in the standby what must or may be presented as, or in lieu of, the issuer's undertaking in the form it left the issuer's control. If the standby was sent by an authenticated SWIFT message from an issuing bank to an advisor, the document to be presented would be the advisor's signed/authenticated message to the beneficiary annexing, or reproducing the text of, the SWIFT message sent by the issuer. There may be no unique undertaking for the beneficiary to present. If, for example, a standby was sent to a beneficiary in an electronic medium, its presentation to the issuer in an electronic medium or as a paper printout would serve merely to identify the standby to be transferred.

The terms "this standby" and "original standby" do not necessarily refer also to amendments. Some standbys state that all amendments must also be presented, and some also require a statement from the beneficiary as to whether it has consented (or not) to each amendment issued by the issuer. Neither should be necessary. An issuer should be able to determine from its own records whether amendments are binding on the issuer and the beneficiary, but it may nonetheless be desirable to address the status of amendments in any standby term requiring presentation of the standby.

[10] Form of payment demand. This ISP98 Form 1 standby incorporates an annexed model form of payment demand to be completed and presented by the beneficiary. Annexing the desired form of payment demand (with any desired beneficiary statement) to a standby is unnecessary but promotes the efficient use of standbys. Requiring a "draft" (or bill of exchange) drawn at sight by the beneficiary on the issuer is neither necessary nor efficient under a standby that undertakes to pay at sight.

A standby that specifies wording in an annexed form of demand is subject to ISP98 Rule 4.09(b) (Identical Wording and Quotation Marks). That subsection requires or permits the beneficiary to complete blank lines or spaces and to correct apparent typographical errors and the like. It is intended to cover practically all circumstances in which a form of beneficiary demand and

statement is annexed to the standby.

If more flexibility is desired, Rule 4.09(a) should be consulted, but flexibility is better introduced by adding alternative wording to the annexed form of demand or otherwise indicating in the annexed form of demand how blank spaces may be completed. If no flexibility whatsoever is desired (e.g., because the demand or statement must be delivered to a third person in a precisely specified form), then Rule 4.09(c) should be consulted, with the understanding that it should be invoked rarely, that it requires use of the word "exact" or "identical" in the standby, and that its use may lead to unintended consequences for the issuer, applicant, or beneficiary.

The phrase “completed as indicated” assumes that the annexed form of demand adequately indicates how it is to be completed (e.g., by the inclusion of instructions and blank lines) and that it is to be dated and signed by the beneficiary. It does not add that the demand be “apparently” signed by the beneficiary or the beneficiary’s “purported” representative, because such additions are more likely to confuse than clarify the allocation of risks under ISP98 and applicable law of payment or non-payment of a forged demand.

ISP98 Rule 4.08 (Demand Document Implied) requires presentation of a documentary demand for payment. ISP98 itself does not require the named beneficiary to present any beneficiary statement.

Some standbys state that they are available by “one or more demands” or by “demand(s)”, rather than by “demand” in the singular. This is unnecessary for the reasons indicated in endnote 17.

[11] Manner of presentation. This standby form is based on the usual practice of sending original documents, sometimes including the original standby, in a package by courier to the issuer’s indicated place of presentation. Presentations by telefax and the like are prohibited unless expressly permitted in the standby or unless the beneficiary is a SWIFT participant or bank sending a demand using SWIFT or other similar authenticated means. See ISP98 Rule 3.06 (Complying Medium of Presentation). ISP98 Rule 1.09(c) (Electronic Presentations) includes defined terms that may be used in a standby that permits electronic presentation.

[12] Place of Presentation. ISP98 Rule 3.01 (Complying Presentation under a Standby) provides that a standby should indicate the place, the location within that place, and the person to whom presentation should be made. ISP98 Rule 3.04 (Where and to Whom Complying Presentation Made) provides default rules. The indicated place of presentation is significant in determining whether a complying demand is timely presented.

Standbys frequently include a requirement that the presentation be addressed to the attention of the Standby Letter of Credit Department or the like, which may prove critical on a last minute presentation. Some standbys also include in the address for presentation a specific floor or office, which, if it is not accessible to the beneficiary, may prove contentious in the case of a last

minute presentation. Beneficiaries and issuers both should avoid testing the limits of such requirements.

A standby may require presentation to the issuer to be made at a place that is not the place of issuance, e.g., to and at the address of a processing agent for the issuer (which could be an affiliate or another bank). A standby may also nominate another branch or bank to receive a presentation and act on that nomination. This standby form does not include any nomination or address issues which arise from a nomination. See ISP98 Rule 2.04 (Nomination).

[13] Time of presentation. ISP98 Rule 3.05 (When Timely Presentation Made) provides that presentation must be made before expiry on the expiration date and that a presentation after business hours is treated as made the next business day. Rule 9.04 (Time of Day of Expiration) provides that expiry occurs at the close of business at the place of presentation.

[14] Expiration. Standbys must contain an expiration date under ISP98 Rule 9.01 (Duration of Standby) and likely also under applicable commercial law and banking regulations. This standby form is based on the common practice of stating a specific calendar date. The stated date should be set sufficiently after the underlying obligation becomes due to allow for drawing after refusal of an initial drawing. If payment of the underlying obligation may be made outside of the standby, the stated date should be set to allow also for drawing after any possible rescission of an outside payment made by an insolvent payor.

Many issuers are subject to laws, regulations, or internal policies that limit their incurrence of obligations that are indefinite or long term. A common response is to set a one year expiration date and allow for automatic annual extensions unless the issuer sends or the beneficiary receives advance notice of non-extension. ISP98 Rule 2.06(a) (When an Amendment is Authorized and Binding) makes "automatic amendments", including extensions of the expiration date, effective without further notification or consent, if the automatic amendment is expressly stated in a standby. ISP98 Form 2 (Model Standby Providing for Extension) focuses on annual automatic extension and other alternatives to a single fixed expiration date.

The expiration date stated in a standby is not necessarily the last day on which a complying presentation may be made under the standby. ISP98 Rules 3.13 (Expiration Date on a Non-Business Day) and 3.14 (Closure on a Business Day and Authorization of Another Reasonable Place for Presentation) extend the expiration date where it falls on a non-business day or on a day the bank is closed for any other reason.

[15] Three days to examine and pay a presentation. ISP98 Rules 2.01(c) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) and 5.01 (Timely Notice of Dishonour) provide for the time an issuer has to honour or dishonour and include a safe-harbor of three business days after presentation. The three day period begins on the business day following the business day of presentation. This optional standby text converts that 3-day safe harbor period in ISP98 into a timing requirement for payment of a complying presentation.

Many so-called financial standbys state a shorter period within which a complying presentation must be paid, and some also state that the shortened period also applies to the time allowed for the issuer to avoid preclusion by giving a notice of dishonour. For example, a standby payable against a simple demand to be presented by a bank beneficiary might state: "Payment of a complying presentation shall be made[, or in the case of a non-complying presentation a notice of dishonour shall be given,] on the first banking day following the banking day on which Issuer receives a presentation from Beneficiary[, if received before noon,][by SWIFT/telefax message at Issuer's following SWIFT address/telefax number]…"

Some standbys permit a longer period for payment, e.g., 30 days after presentation or 10 days after a presentation is determined to comply. Lengthening the time for honour would not, without more, lengthen the timing requirements of ISP98 Rule 5.01 (Timely Notice of Dishonour) for giving a notice of dishonour or for precluding defenses under ISP98 Rule 5.03 (Failure to Give Timely Notice of Dishonour).

[16] Place and method of payment. If a standby, including an annexed form of demand, does not state the method of payment, then an issuer may voluntarily follow the presenter's request. ISP98 Rule 5.08 (Cover Instructions/Transmittal Letter) permits an issuer to deal with the presenter and to follow instructions accompanying a presentation. Similarly, ISP98 Rule 6.10 (Reimbursement for Payment Based on an Assignment) protects an issuer's reimbursement rights in cases of payment to an acknowledged assignee of standby proceeds. ISP98 Rule 2.01(e) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) provides that honour by payment is to be made in immediately available funds. This optional standby text facilitates payment by wire transfer in response to a request duly made by the beneficiary.

Unless the standby otherwise states, an issuer is not required to pay anyone other than a beneficiary, a nominated person, or an acknowledged assignee of standby proceeds and is not required to pay anywhere other than at the place of presentation. See ISP98 Rule 6 (Transfer, Assignment, and Transfer by Operation of Law). Payment may be made at the place of presentation by sending a bank check to the order of the beneficiary or by initiating a wire transfer.

If payment by check is the sole desired method of honour, the following may be substituted: "Payment shall be made by Issuer's check payable to Beneficiary sent to Beneficiary's above-stated address by registered mail or [*inter*]nationally recognized courier or other means of receipted delivery to Beneficiary."

If payment by wire transfer is the sole desired method of honour, the following standby text may be substituted: "Payment shall be made by wire transfer to an account of Beneficiary as follows: **[name, address, and routing number of Beneficiary's bank, and name and number of Beneficiary's account]** or to such other bank account of Beneficiary as Beneficiary may duly request of Issuer". An issuer's response to a beneficiary request may be affected by regulatory requirements limiting payment to a permissible account at a permissible financial institution

located in a permissible country. The annexed form of demand and statement incorporated into this ISP98 Form 1 standby contains model wording for a beneficiary's request for payment by wire transfer. Including a detailed method of payment in a standby may deter forged beneficiary demands, as well as avoid delays resulting from the issuer's receipt of an inadequate request as to the method of payment.

No matter what a standby, demand form, or separate request for routing payment may state, applicable law, e.g., a court or government agency order, may block payment. Applicable law may also allocate the risks of loss in case of payment to the wrong person.

[17] More than one drawing. It is unnecessary to state that a beneficiary may make multiple drawings or drawings for less than the full amount available. A standby that undertakes to honour "a demand" (in the singular) does not affect the beneficiary's right to present more than one demand under standard practice applicable to standby (and commercial) letters of credit. ISP98 Rule 3.08 (Partial Drawings & Multiple Presentations; Amount of Drawings) permits both partial and multiple drawings unless prohibited in the standby. If a standby is to be honoured once only, then the standby should state that affirmatively or, as indicated in ISP98 Rule 3.08(d), state "multiple drawings prohibited".

[18] Reduction by honour. It is unnecessary to state that the amount available under a standby is reduced by the amount of any drawing that is honoured. This is because honour discharges (rather than amends or cancels) the issuer's obligations and because ISP98 Rule 1.10(c)(ii) (Redundant or Otherwise Undesirable Terms) presumes that reinstatement is not intended. ISP98 Form 3 (Model Standby Providing for Reduction and Incorporating Annexed Form of Reduction Demand) focuses on reduction, including reduction to zero, by beneficiary demand and by other optional terms permitting or requiring reductions in the amount available under a standby.

[19] Incorporation of ISP98; law, court, arbitration, and sanctions. Incorporation of ISP98 into an undertaking that is payable against the presentation of documents should qualify the undertaking as independent under applicable law. ISP98 invokes letter of credit law by emphasizing the letter of credit aspects of a standby and its independence in ISP98 Rules 1.06(c) (Nature of Standbys) and 1.07 (Independence of the Issuer-Beneficiary Relationship). See *Team Telecom Int'l v. Hutchison 3G UK Ltd*, 2003 EWHC 762 (Q.B. Div'l Ct.) [England], abstracted at *2004 Annual Survey of Letter of Credit Law & Practice* 335 (bond subject to ISP98 is an independent undertaking).

It is unnecessary for a standby to recite that it is independent or that it is enforceable without regard to the validity of any claim of performance or non-performance in the underlying transaction. It is unnecessary for a standby to add a recital (including an "integration" or "merger" clause) that would deny or limit the effect of any document or other matter mentioned in the standby or of any negotiations leading up to or following standby issuance. Such clauses and recitals risk limiting the various ISP98 rules that provide for the standby's independence.

Where a choice-of-law clause is included in a standby, most courts will give effect to it. Otherwise, a court will likely apply its own conflict-of-laws' rules. Conflict-of-laws' rules affect the legal standards for compliance of any presentation, for the scope of any fraud/abuse exception, for the availability of any excuse based on government sanctions, etc. Under many legal systems, the conflict-of-laws' rules provide that the law at the place of issuance of the standby (or confirmation) should govern the issuer's (or confirmer's) obligations. See, e.g., the UN Convention on Independent Guarantees and Standby Letters of Credit, Articles 21 (Choice of applicable law) and 22 (Determination of applicable law). However, courts may hear a wrongful dishonour claim filed other than where the issuer (or confirmer) is located, may apply different conflict-of-laws' rules, and may determine, e.g., that the law of the place where the beneficiary is located should govern.

As indicated, most courts will respect a choice-of-law clause and a choice-of-exclusive-forum clause in a standby (or confirmation of a standby). Including a choice of law clause or an exclusive forum clause or both fosters certainty. E.g.: "Issuer's obligations under this Standby are governed by the laws of **[State]**. The courts located in **[State]** shall have exclusive jurisdiction over any action to enforce Issuer's obligations under this Standby."

The Preface to ISP98 includes a suggested arbitration clause: "This Standby [*undertaking*] is issued subject to ISP98, and all disputes arising out of it or related to it are subject to arbitration under ICLOCA Rules (1996)." (The ICLOCA Rules, which are based on the UNCITRAL Rules of Arbitration, are available at www.icloca.org. The International Center for Letter of Credit Arbitration is located in metropolitan Washington, D.C., at 20405 Ryecroft Court, Montgomery Village, MD 20886 USA.)

Particularly if the standby does not choose applicable law, the issuer may wish to consider including a "sanctions" clause covering sovereign compulsion excusing the issuer, e.g.: "Issuer disclaims liability for delay, non-return of documents, non-payment, or other action or inaction compelled by a judicial order or government regulation applicable to Issuer."

A standby consists of obligations of the issuer limited by its terms and conditions. Accordingly, a choice of law or forum or both in a standby applies to those issuer obligations and not to the obligations of any confirmer or other person. There is no problem under a straight standby that states that "this standby is governed" by the chosen law or that any litigation under it is limited to the chosen court, but this same wording might prove confusing when included in a standby that nominates another person to advise, confirm, or otherwise act on the standby.

[20] Communications. This optional clause or a variation of it is particularly apt for a standby that is long term or that provides for communications from or to the beneficiary (apart from payment demands). If a beneficiary requires greater certainty that its request to amend its address will be given effect, then the standby should expressly provide for automatic amendment against presentation of a complying beneficiary demand for an address change. Standby language with a

demand form for this purpose may be adapted from ISP98 Forms 3 and 4 providing for reduction and transfer on demand by the beneficiary.

[21] Demand Date. ISP98 Rule 4.16(b)(ii) (Demand for Payment) provides that a demand must contain an issuance date, and ISP98 Rule 4.06 (Date of Documents) provides that its issuance date may not be later than the date of its presentation. To override that rule, e.g., to permit post-dated documents, the following clause may be added to the Standby text: "The issuance date or any other date on any document, including the required demand, may be a date on, before, or after the date the document is presented under this Standby."

[22] Addressee. The information in the text of the standby indicating where, how, and to whom a presentation is to be made under the standby should be repeated in the demand form. See ISP98 Rules 3.01 (Complying Presentation under a Standby), 3.04 (Where and to Whom Complying Presentation Made), and 3.06 (Complying Medium of Presentation). Particular attention should be given to the possibility that a standby may require presentation at an address that differs from the issuer's letterhead address.

[23] Standby identification. A demand form should identify the standby by including the information in the standby text that identifies it, particularly the issuer's reference number. See ISP98 Rules 3.01 (Complying Presentation under a Standby) and 3.03 (Identification of Standby).

[24] Demand. This model form of annexed demand should satisfy the requirements of ISP98 Rules 4.16 (Demand for Payment) and 4.17 (Statement of Default or other Drawing Event), so that, when the beneficiary completes it as indicated, it will include a demand for payment of a stated amount, be dated and signed, and contain any required beneficiary statements.

[25] Beneficiary statements. Standbys commonly require presentation of beneficiary statements and commonly combine them with the required form of demand for payment. Words other than "states", such as "certifies", "represents", "warrants", "promises", or a combination of those words, are also used and may be preferable in the context of the underlying transaction. Any such word of assurance, when required to be included in a document presented under a standby, may give rise to a claim against the beneficiary who obtains payment under the standby. The nature and sufficiency of such claim may depend on the precise wording included in the demand, the identity of the claimant, and the status of any related claims based on the obligations intended to be supported by the standby.

The applicant or issuer or both may prefer a combination of specific representations and undertakings from the beneficiary. The beneficiary may prefer no such wording or only conclusory wording qualified by the beneficiary's reference to "good faith" belief or the like. The applicant or issuer or both may prefer that the beneficiary make its statements expressly to the applicant or issuer or both.

ISP98 Rule 4.12 (Formality of Statements in Documents) provides guidance on standby requirements for statements that are to be "sworn to", "witnessed", "legalized", or the like.

It should be unnecessary to include in a demand form that the amount demanded is available under the standby, because that amount should be determinable without dependence on any such statement.

[26] "Applicant" as underlying obligor. This demand form uses "Applicant", which is a defined term in the text of the standby, and assumes that the applicant and beneficiary are parties to an underlying agreement that establishes the obligations to be supported by the standby. See endnotes 1 and 30.

[27] Obligated/in default. This statement indicates that the applicant is "obligated to pay" the amount demanded, not that there is a "default". A default statement is inapt where the amount demanded is payable on the date demanded without regard to the occurrence or continuance of a default or where "default" is not adequately defined in the documentation for the underlying obligations or where "default" may require that an action be taken that may be prohibited under laws triggered by the insolvency of the applicant or other party.

[28] Unpaid. The term "unpaid" in the optional "due and unpaid" recital may raise a question where the applicant has made a direct payment to the beneficiary but the funds paid are subject to recapture by an insolvency representative of the applicant. It should be possible for a beneficiary in that context to state, without running afoul of a fraud or abuse exception under applicable letter of credit law, that the underlying obligation remains unpaid where a direct payment has been received subject to a credible claim that the direct payment is voidable and must be returned.

[29] Underlying obligation. Although some standbys are payable on simple demand, the applicant, beneficiary, or issuer may insist that a demand under a standby identify the underlying obligation, obligor, and obligee, particularly where there may be no single underlying agreement between the applicant and beneficiary that establishes the underlying obligations and provides that those obligations be supported by a standby.

[30] Applicant-beneficiary relationship. This model form of annexed demand assumes that the standby supports one or more obligations of the applicant to the beneficiary. Under commercial and regulatory laws, the issuer, any nominated bank, the applicant and beneficiary, and, where different, the underlying obligor and obligee may need to identify the underlying obligations intended to be supported by the standby and to be satisfied or secured by the proceeds of a drawing under the standby. Accordingly, this form of demand should be redrafted if, e.g., the applicant is a surety for the underlying obligor or the beneficiary is a creditor of the underlying obligee. Additionally, the underlying documentation should be drafted to provide for the pre- and post-honour obligations of the applicant and beneficiary (and, where different, of the underlying obligor and obligee) to each other, particularly if the named applicant has or intends

to claim the rights of an ordinary guarantor or surety. In this regard, it may be desirable for the beneficiary's statement to refer expressly to the underlying obligations, as they may be amended by the obligor and obligee, without (or with) the further consent of the applicant.

[31] Use of proceeds. This optional beneficiary statement is unnecessary if the underlying agreement adequately provides for the use of all proceeds from a drawing under the standby and if the applicant reimburses the issuer. Otherwise, some mention in the form of demand of the relationship of any standby proceeds to the underlying obligation is helpful in answering post-honour questions about the disposition of any excess standby proceeds. Absent such a provision, the "independence" of the standby obligation may hinder appropriate post-honour accounting for the use of funds received under a standby.

[32] Proceeds as cash collateral. Where the proceeds cannot or might not be used to "satisfy" the applicant's obligations, the demand form should indicate that the proceeds will be used to "secure" them. This consideration is important under standbys that are intended to be used, at least in some circumstances, to fund the applicant's underlying obligation to provide cash collateral. The most common circumstance involves standbys that may expire before the underlying obligations become fully due and payable.

[33] Accounting to issuer for unused proceeds. The issuer may want to take a security interest in the applicant's rights to unused proceeds and/or require the beneficiary to state, e.g.,: "…and that Beneficiary will account to Issuer or Applicant, as their interests may appear, for any proceeds that are not so used."

[34] Request for wire transfer to beneficiary's account. This term in the demand form is unnecessary if the text of the standby includes satisfactory wire transfer information for payment to the beneficiary. See endnote 16.

Issuers are not required to pay wherever, however, or whomever the beneficiary requests, unless the standby so states. Under ISP98 Rule 5.08 (Cover Instructions/Transmittal Letter), issuers are permitted to follow a request to pay by wire transfer to the beneficiary's account, subject to timely receipt of customary account information and deduction of customary wire transfer charges and due consideration of any regulations or bank policies affecting wire transfer of funds to the requested country, bank, and account.

A request to pay to another's account is a request for acknowledgement of an assignment of proceeds, which is subject to the special rules in ISP98 Rules 6.06-6.10 (Acknowledgement of Assignment of Proceeds), as well as laws protecting issuers and applicants and other laws regulating money laundering, etc.

To deter forged demands, and to address anti-money-laundering concerns, this model form of request for payment by wire transfer states that payment is to be made to the named beneficiary at a specified beneficiary account at a specified bank location.

[35] Signer authentication. This demand form requires the signer to indicate in the signature line that the demand and statement are made by the named beneficiary located at the address stated in the standby. Accordingly, the beneficiary's name and address should be stated in this demand form when the standby incorporating it is issued.

[36] Original signature. What is an original signature depends on the mode of communication. See ISP98 Rules 1.09(a) (Defined Terms) ("Signature") and 3.06(d) (Complying Medium of Presentation).

[*IIBLP as of 10 May 2012*]

ISP98 Form 2
Model Standby Providing for Extension and Incorporating Annexed Form of Payment Demand with Alternative Non-Extension Statement*

[name and address of beneficiary] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]** ("Applicant"), we **[name and address of issuer at place of issuance]** ("Issuer") issue this irrevocable standby letter of credit number **[reference number]** ("Standby") in favour of **[name and address of beneficiary]** ("Beneficiary") in the maximum aggregate amount of **[currency/amount]**.

Undertaking. Issuer undertakes to Beneficiary to pay Beneficiary's demand for payment in the currency and for an amount available under this Standby and in the form of the Annexed Payment Demand completed as indicated and presented to Issuer at the following place for presentation: **[address of place for presentation]**, on or before the expiration date.

Expiration. The expiration date of this Standby is **[date]**.[1]

Extension. The expiration date of this Standby shall be automatically[2] extended[3] for successive one year periods, unless Issuer notifies Beneficiary by registered mail or other receipted means of delivery sent[4] to Beneficiary's above-stated address **[30]**[5] or more days before the then current expiration date that Issuer elects not to extend the expiration date.[6] The expiration date is not subject to automatic extension beyond **[date]**, and any pending automatic one-year extension shall be ineffective beyond that date.[7] [*The expiration date may also be extended in accordance with the terms of an amendment issued by Issuer to which Beneficiary consents and in accordance with ISP98 rules on closure of the place for presentation on the expiration date.*][8]

[*Payment. Payment against a complying presentation shall be made within 3 business days after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary. An advice of such payment shall be sent to Beneficiary's above-stated address.*]

[*Drawing. Partial and multiple drawings are permitted.*]

[*Reduction. Any payment made under this Standby shall reduce the amount available under it.*]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).

[*Communications. Communications other than demands may be made to Issuer by telephone, telefax, or SWIFT message, to the following:* ***[numbers/addresses]***. *Beneficiary requests for amendment of this Standby, including amendment to reflect a change in Beneficiary's address, should be made to Applicant, who may then request Issuer to issue the desired amendment.*][9]

[Issuer's name]

[signature]
Authorized Signature

Annexed Payment Demand

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. [**reference number**], dated **[date]**, issued by **[Issuer's name]** ("Standby")

The undersigned Beneficiary demands payment of [INSERT CURRENCY/AMOUNT] under the Standby.

Beneficiary states that

[INSERT ONE OF THE FOLLOWING ALTERNATIVE STATEMENTS[10]:

Applicant is obligated to pay to Beneficiary the amount demanded[, *which amount is due and unpaid*] under[*or in connection with*] the agreement between Beneficiary and Applicant titled [**agreement title**] and dated [**date**].[11] [*Beneficiary further states that the proceeds from this demand will be used to satisfy the above-identified obligations and that Beneficiary will account to Applicant for any proceeds that are not so used.*]

or[12]

the Standby is set to expire fewer than **[30]** days from the date hereof, because Issuer has given a notice of non-extension of the Standby,[13] and[14] the amount demanded is required as cash collateral to secure the unmatured or contingent obligations of Applicant under[*or in connection with*] the agreement between Beneficiary and Applicant titled **[agreement title]** and dated **[date]**. Beneficiary further states that the proceeds from this demand will be used to secure[15] the above-identified obligations and then to satisfy them as they become absolute and due and that Beneficiary will account to Applicant[16] for any proceeds that are not so used.]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: **[**INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].

[**Beneficiary's name and address**]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE]

[Before the standby is issued, all text in **[bold]** should be completed, and optional text in [*italics*] should be included or deleted (or redrafted). Text in the annexed demand form preceded by "INSERT" (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the beneficiary prepares and presents a demand.]

****

This ISP98 Form 2 model standby repeats the text of ISP98 Form 1. It adds a provision for automatic extension and incorporates a model form of payment demand that adds an alternative beneficiary statement demanding payment because of the issuer's action resulting in non-extension of the expiration date of the standby. Like ISP98 Form 1, this Form 2 is intended to be self-contained and, absent special circumstances, useable without extended reference to the text of ISP98.

The endnotes to this standby include alternative and other optional terms of particular relevance to standbys providing for automatic amendment of an expiration date, as well as references to relevant ISP98 rules. See the ISP98 Form 1 endnotes for explanation of wording that is common to ISP98 Forms 1 and 2 and for alternative and optional wording for general terms common to both forms. (There are more than 30 endnotes to Form 1 that are not repeated in this Form 2.)

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Expiration. ISP98 Rule 9.01 (Duration of Standby) provides that "A standbys must: (a) contain an expiration date or (b) permit the issuer to terminate the standby upon reasonable prior notice

or payment". Commercial law and banking regulations are likely to impose similar requirements. As reflected in ISP98 Form 1, a standby may set an expiration date and leave the possibility of shortening or extending that date to future amendment(s) issued by the issuer to which the beneficiary consents, as provided in ISP98 Rule 2.06(b)-(d) (When an Amendment is Authorised and Binding). Also, a beneficiary may seek the issuer's consent to an amendment of the expiration date by requesting the amendment or by making an extend or pay demand.

[2] Automatic amendment. Many issuers are subject to laws, regulations, or internal policies that limit their incurrence of obligations that are indefinite or long term. A common response to an applicant's request for a medium or long term standby is to set a one year expiration date and then state in the standby that it automatically extends for successive one-year periods unless the issuer sends, or the beneficiary receives, advance notice of non-extension, as provided in ISP98 Rule 2.06(a) (When an Amendment is Authorised and Binding). This ISP98 Form 2 reflects that common response.

Alternative responses include the following model clause for automatic early termination of the standby based on the issuer's giving advance notice to the beneficiary, e.g.: "The expiration date of this Standby is **[date]**. The expiration date shall be automatically amended to an earlier date if Issuer notifies Beneficiary of the proposed earlier expiration date by registered mail or other receipted means of delivery sent to Beneficiary's above-stated address **[30]** or more days before the proposed earlier expiration date stated in the notice."

Another alternative is based on early payment, e.g., "The expiration date of this Standby is **[date].** The expiration date shall be automatically amended to an earlier date if Issuer notifies Beneficiary by registered mail or other receipted means of delivery sent to Beneficiary's above-stated address that Issuer elects to terminate this Standby with Issuer's payment to Beneficiary of the full amount available under this Standby and payment is made to Beneficiary, whereupon this Standby shall expire." See ISP98 Rule 9.01(b) (Duration of Standby).

ISP98 Rule 2.06(a) (When an Amendment is Authorized and Binding) makes "automatic amendments" effective without further notification or consent if the automatic amendment is expressly stated in a standby. Accordingly, it is desirable to include the word "automatic" in any standby clause intended to make an amendment effective based on the terms of the standby and not by obtaining the beneficiary's consent. It is unnecessary to recite that an automatic extension is "without amendment" or that an automatic extension clause is a "condition".

[3] Automatic extension. The words "extend" and "non-extension" are used, rather than "renew" and "non-renewal", to avoid any doubt that the intent is to amend, rather than replace, the standby.

It is not desirable to include the word "evergreen" in an automatic extension clause. The word "evergreen" is popularly used to refer to automatic extension clauses, such as the one included in this ISP98 Form 2. However, this word cannot substitute for, or usefully supplement, an automatic extension clause. See ISP98 Rule 1.10(c)(ii) (Redundant or Otherwise Undesirable Terms).

[4] Send/receive. Automatic extension clauses vary in the extent to which they spell out where and how a notice of non-extension must or may be sent to, or be received by, the beneficiary in order to establish an expiration date that is not subject to further automatic extension. For alternative wording, consider: "…is sent to Beneficiary's above-stated address by registered mail or by [inter]nationally recognized courier or is received by Beneficiary at Beneficiary's above-stated or current address…." Under ISP98 Rule 4.11(c)(ii) (Non-Documentary Terms or Conditions), standby requirements based on when, where, and how issuer notices are sent or received by the issuer or beneficiary are effective. However, there may be practical difficulties in proving when an issuer's non-extension notice was sent to or received by the beneficiary. Strict compliance concepts applicable to beneficiary presentations under a standby are sometimes applied to issuer notices to a beneficiary. Some standbys address these concerns by providing alternative beneficiary addresses or by providing that timely actual receipt of notice by the beneficiary is sufficient.

If notice by e-mail, telefax, or the like is also to be permitted, then the automatic extension clause should state the alternative, e.g. "Such notice may also be given by [*e-mail*] [*telefax*] [*authenticated SWIFT message*] sent to the following Beneficiary [*address*][*number*].…"

[5] 30 days/one year. A 30-day period for giving or receiving a notice of non-extension is common, but shorter (e.g., 15 days) and longer (e.g., 60 days) periods are also common. Although unnecessary, "calendar day" may be substituted for "day" to emphasize the distinction between "business day" and "banking day" which are defined in ISP98 Rule 1.09(a) (Definitions) and "day" which is not defined. The length of the period is affected by the length of time expected for (i) the issuer to re-approve the applicant's credit, (ii) the beneficiary to draw as permitted by the standby and the underlying transaction, and (iii) the applicant to replace the standby.

A one-year period for setting the initial expiration date and for the duration of automatic extension periods is very common. It is based on the common practice of bank issuers that annually re-evaluate applicant credit-worthiness.

[6] Retraction of non-extension notice. Standby operations personnel may not receive credit approval for extension before the date required to initiate sending a timely non-extension notice and, as a result, may issue a notice of non-extension and later receive credit approval for extension. The following optional model clause would permit a full right of retraction: "At any time before the next expiration date Issuer may retract its notice of non-extension and thereby automatically extend the expiration date as if its notice of non-extension had not been sent or received and may treat any pending (unhonoured) demand for payment based on non-extension as automatically retracted by Beneficiary."

[7] Final expiration date. An end date for automatic extensions, even if it is set many years out, is desirable for record keeping purposes, particularly to avoid having to retain indefinitely proof that a standby was terminated by expiration following an effective notification of non-extension (or was honoured or otherwise reduced to zero).

[8] Extension under ISP98 Rules 3.13 (Expiration Date on a Non-Business Day) and 3.14 (Closure on Expiry Date). The initial or automatically extended expiration date stated in a standby may not be the last day on which a presentation may be made. ISP98 provides for extensions for a presentation that is received during a weekend or holiday or that is attempted during a business day at a place of presentation that is closed for any reason. Separately, ISP98 Rule 9.03(b) (Calculation of Time) provides that an extension period starts on the calendar day following a stated expiration date that falls on a day when the issuer is closed. (This rule is intended to keep the same calendar date as the expiration date under an annually extended standby.)

[9] Communications. See ISP98 Form 1 endnote 20. This optional clause is particularly apt for a standby that is long term or otherwise more complex than most standbys, such that communication from or to the beneficiary (apart from payment demands) may be expected. An issuer may wish to expand this clause or the clause on giving notice of non-extension to the beneficiary, to assure that effect will be given to a notice duly sent but not (provably) received by the beneficiary, "A notice shown to have been delivered to the Beneficiary's above address by mail or courier certificate, invoice, or the like shall be deemed received by Beneficiary and effective not later than 5 Business Days after the date of delivery shown thereon."

[10] Alternative Statements. Depending on the terms of the underlying obligation, an issuer's non-extension notice may entitle the beneficiary to a payment either that satisfies the underlying obligation or serves as cash collateral for an underlying obligation or that is not yet due. ISP98 Form 2 contemplates that the beneficiary will present separate demands and statements if the beneficiary is entitled to make partial demands of both types.

[11] First alternative statement (drawing to satisfy underlying obligation). The first alternative beneficiary statement is substantially the same as the beneficiary statement in ISP98 Form 1. This first alternative statement might be apt for a drawing made after sending/receipt of a non-extension notice, particularly if the underlying agreement entitled the beneficiary to accelerate an underlying debt obligation upon the imminent expiration of standby support. Any such underlying agreement could limit the beneficiary's right to accelerate to situations in which there was no retraction of the non-extension notice sent/received and no substitute standby was issued.

[12] Second alternative statement (drawing to cash collateralize underlying obligation). The second alternative statement would be apt for a drawing made after sending/receipt of a non-extension notice, particularly if the first alternative statement requires a statement that the amount demanded is due and if the underlying agreement does not treat imminent expiration of the standby as accelerating the underlying payment obligations.

[13] Extend or pay demands. ISP98 Rule 3.09 (Extend or Pay) provides that an "extend or pay" demand must be examined for compliance with the standby's terms and conditions for honouring payment demands. Imminent expiration would not excuse compliance with a requirement that a payment demand state that the underlying obligation is in default or the like. It would not excuse compliance with a requirement that a payment demand state that the issuer has sent a notice of

non-extension. Accordingly, if the standby is to facilitate extend or pay demands, the standby text and the required form of payment demand in this model ISP98 Form 2 should be re-worded.

[14] No retraction or standby substitution. The required beneficiary statement might here add a statement that no retraction of the non-extension notice has been timely sent/received and that no permitted substitute standby (or other equivalent security) has been timely sent/received. In such case, the 30 day period stated in the automatic extension clause in this ISP98 Form 2 should be reduced, e.g., to 15 days, to allow time for retraction or permitted standby substitution. It is possible to include all of the features of a permitted standby substitution (or for the tender of permitted equivalent security), but ordinarily what is permissible should be spelled out in the underlying agreement and cross referenced in the beneficiary's statement.

[15] Proceeds as cash collateral. Where the proceeds cannot or might not be used to "satisfy" the Applicant's obligations, it may be appropriate to state that the proceeds are being used to "secure" them. The terms permitting a drawing and then holding of cash collateral should be stated in an underlying agreement between the applicant and beneficiary, particularly if the cash collateral is to be held in an interest bearing or other special account. Such terms may be stated also in the required form of beneficiary statement regarding the basis for the drawing and subsequent use of standby proceeds as security.

[16] Accounting for proceeds. As noted in ISP98 Form 1, the issuer may wish that the demand form state that the beneficiary must account to the issuer for any unused proceeds resulting from a drawing based on the issuer's advance notice of non-extension and to take further steps to protect its interest in such unused proceeds.

[*IIBLP as of 27 June 2012*]

ISP98 Form 3
Model Standby Providing for Reduction and Incorporating Annexed Form of Reduction Demand*

[name and address of beneficiary] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]** ("Applicant"), we **[name and address of issuer at place of issuance]** ("Issuer") issue this irrevocable standby letter of credit number **[reference number]** ("Standby") in favour of **[name and address of beneficiary]** ("Beneficiary") in the maximum aggregate amount of **[currency/amount]**.

Undertaking. Issuer undertakes to Beneficiary to pay Beneficiary's demand for payment in the currency and for an amount available under this Standby and in the form of the Annexed Payment Demand completed as indicated and presented to Issuer at the following place for presentation: **[address of place for presentation]**, on or before the expiration date.

Expiration. The expiration date of this Standby is **[date]**.

[*Payment. Payment against a complying presentation shall be made within 3 business days after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary. An advice of such payment shall be sent to Beneficiary's above-stated address.*]

Reduction. Any payment made under this Standby shall reduce the amount available under it. Also, the amount available under this Standby shall be automatically reduced[1] in accordance with the terms of Beneficiary's reduction demand(s)[2] in the form of the Annexed Reduction Demand completed as indicated and presented to Issuer at the above-stated place for presentation.[3]

[*Partial and multiple drawings are permitted.*]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).

[*Communications. Communications other than demands may be made to Issuer by telephone, telefax, or SWIFT message, to the following:* ***[numbers/addresses]****. Beneficiary requests for amendment of this Standby, including amendment to reflect a change in Beneficiary's address, should be made to Applicant, who may then request Issuer to issue the desired amendment.*]

[Issuer's name]

[signature]
Authorized Signature

Annexed Payment Demand

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby")

The undersigned Beneficiary demands payment of [INSERT CURRENCY/AMOUNT] under the Standby.

Beneficiary states that Applicant is obligated to pay to Beneficiary the amount demanded[, *which amount is due and unpaid*] under[*or in connection with*] the agreement between Beneficiary and Applicant titled **[agreement title]** and dated **[date]**.

[*Beneficiary further states that the proceeds from this demand will be used to satisfy the above-identified obligations and that Beneficiary will account to Applicant for any proceeds that are not so used*.]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].

[Beneficiary's name and address]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE]

Annexed Reduction Demand

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby")

The undersigned Beneficiary demands[4] reduction of the amount available under the Standby to the maximum aggregate of [INSERT CURRENCY/AMOUNT]).

Beneficiary states that this Demand for Reduction is based on Beneficiary's determination regarding the maximum amount of standby support required to be provided to Beneficiary by Applicant under[*or in connection with*] the agreement between Beneficiary and Applicant titled **[agreement title]** and dated **[date]**.[5]

Beneficiary's demand and statements are made as of the date hereof.

[Beneficiary's name and address]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE][6]

[Before the standby is issued, all text in **[bold]** should be completed, and optional text in [*italics*] should be included or deleted (or redrafted). Text in the annexed demand forms preceded by "INSERT" (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the beneficiary prepares and presents a demand.]

****

This ISP98 Form 3 model standby repeats the text of ISP98 Form 1. It adds standby text and incorporates a model reduction demand form that obligates the issuer to reduce the amount available under the standby upon receipt of a reduction demand completed and presented by the beneficiary. Like ISP98 Form 1, this Form 3 is intended to be self-contained and, absent special circumstances, useable without extended reference to the text of ISP98.

The endnotes to this standby include alternative and other optional terms of particular relevance to standbys providing for on demand or automatic reduction (including reduction to zero), as well as references to relevant ISP98 rules. See the ISP98 Form 1 endnotes for explanation of wording that is common to ISP98 Forms 1 and 3 and for alternative and optional wording for general terms common to both forms. (There are more than 30 endnotes to Form 1 that are not repeated in this Form 3.)

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Reduction by beneficiary demand. If it is expected that the amount available may be reduced (including a possible reduction to zero) before expiry, other than by honour of payment demands, then it may be desirable to simplify the process of reducing the standby by adding a term permitting the beneficiary to demand reduction(s) by presentation of a specified document. Otherwise, a request for reduction (including a reduction to zero) must be processed as an amendment (or cancellation) requiring the consent of the issuer as well as the beneficiary and, as a practical matter, the applicant, resulting in the application of ISP98 Rule 2 (Obligations) and Rule 7 (Cancellation). Reduction by beneficiary demand is "automatic" in that the standby obligates the issuer to give immediate effect to the beneficiary's presentation of a complying demand for reduction. For an automatic cancellation clause, see ISP98 Form 7 (automatically cancelling standby if not timely confirmed).

[2] Multiple demands for reduction. Because there is no ISP98 rule addressing multiple demands for reduction, their availability is affirmatively indicated by the addition of "(s)".

[3] Automatic reduction. If the timing and amount of any reductions are determinable at the time of standby issuance, then the standby may include an automatic reduction term, e.g.: "The amount available under this standby shall be reduced automatically to **[currency/amount]** on **[date]** at the close of business at the above-stated place of presentation. An amount that is available on the banking day on which a complying demand for payment is presented shall not be affected by any later automatic reduction" Such automatic reductions should be described as reductions to a new aggregate maximum amount available and not as reductions of a stated amount. Otherwise, additional wording might be required to indicate whether or not an automatic reduction is affected by any prior or pending demands for partial payment.

As indicated in ISP98 Form 1, endnote 17, it is unnecessary to state that the amount available under a standby is reduced by honour of a payment demand. However, if a standby includes a term that reinstates any honoured amount (e.g., after honour of a drawing to fund a periodic interest payment due on an underlying debt obligation) or a term that automatically reduces the amount available (e.g., with the passage of time) or permits a reduction (e.g., by presentation of a document evidencing a direct partial payment of an underlying debt obligation), then it may be desirable for the standby to state that honour reduces the amount available and to relate that statement to any other reduction event or reinstatement event to be included in the standby.

A statement in a standby that a payment made by an applicant to a beneficiary shall reduce the amount available under the standby may constitute a "non-documentary condition". Under ISP98 Rule 4.11 (Non-Documentary Terms or Conditions), a non-documentary condition must be disregarded. Accordingly, an applicant-to-beneficiary payment will not reduce the amount available under a standby unless the standby provides for reduction based on the issuer's own records of a payment made by or through the issuer (or the standby provides for reduction against a presentation to the issuer of a document evidencing or reciting that the payment was made).

Standbys supporting the applicant's accounting to the beneficiary for advance payments received frequently provide that the amount available under the standby must reduce pro rata as shipments are made or invoices are sent or paid. Such provisions are also subject to ISP98 Rule 4.11(Non-Documentary Terms or Conditions) and are best handled by identifying documents or banking activities to which the issuer has access, e.g., by relating pro rata reductions under an advance payment standby to the issuer's negotiation or receipt of commercial documents as a nominated bank under a commercial letter of credit paying the purchase price less the pro-rata advance payment.

If payment under a standby may be made by the issuer at the request of the applicant or on the issuer's own initiative, then the standby should affirmatively provide for such payment, preferably by specifying in the standby the beneficiary account to which such payment must be made with an undertaking to send an advice of payment to the beneficiary (and applicant). This kind of standby provision may be worded as a payment demand authorized by the beneficiary to be made in its name or may be worded as a beneficiary consent to automatic reduction against such payment, whether considered to have been under or outside the standby. See ISP98 Form 2, endnote 2, for a model standby term permitting the issuer to initiate early expiration by making full payment to the beneficiary.

[4] Demand for reduction. This model form of reduction demand is called a "demand" for the sake of clarity. It is not a model form of full or partial cancellation to be used with a standby that is silent on the topic. It is to be used with a standby that obligates the issuer to give effect to a beneficiary demanded reduction. Otherwise, an issuer may exercise considerable discretion before giving effect to a request to reduce the amount available or to amend, cancel, or release obligations under a standby, as provided in ISP98 Rule 2.06 (When an Amendment is Authorised and Binding) and Rule 7 (Cancellation). Until the issuer recognizes a requested reduction, the applicant remains liable to pay fees and contingently liable to reimburse based on the maximum amount available under the standby. For the avoidance of doubt, the standby text uses the word "automatic" to clarify that no issuer (or applicant) consent is required, merely presentation of a complying reduction demand. See ISP98 Rule 2.06(a) (When an Amendment is Authorized and Binding).

[5] Statement of continuing requirements for standby support. A standby that permits reduction by the presentation of a demand or other documents typically arises out of an underlying agreement that obligates the beneficiary to the applicant to initiate a reduction when a contractual milestone is met. In their negotiation of their underlying contractual obligations and the related standby terms, the contracting parties may require a more specific beneficiary statement regarding the basis for a demanded reduction.

[6] Authentication. This annexed form of reduction demand requires the same level of authentication as the annexed form of payment demand. ISP98 Rule 7 (Cancellation) lists additional conditions that the beneficiary, applicant, or issuer might wish to consider to deter unauthorized reduction demands.

[*IIBLP as of 31 March 2012*]

ISP98 Form 4
Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand*

[name and address of beneficiary] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]** ("Applicant"), we **[name and address of issuer at place of issuance]** ("Issuer") issue this irrevocable standby letter of credit number **[reference number]** ("Standby") in favour of **[name and address of beneficiary]** ("Beneficiary") in the maximum aggregate amount of **[currency/amount]**.

Undertaking. Issuer undertakes to Beneficiary to pay Beneficiary's demand for payment in the currency and for an amount available under this Standby and in the form of the Annexed Payment Demand completed as indicated and presented to Issuer at the following place for presentation: **[address of place for presentation]**, on or before the expiration date.

Expiration. The expiration date of this Standby is **[date]**.

[*Payment. Payment against a complying presentation shall be made within 3 business days after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary. An advice of such payment shall be sent to Beneficiary's above-stated address.*]

[*Reduction. Any payment made under this Standby shall reduce the amount available under it.*]

[*Partial and multiple drawings are permitted.*]

Transfer.[1] This Standby is transferable.[2] Beneficiary's drawing rights under this Standby shall be transferred in their entirety by presentation of a demand[3] in the form of the Annexed Transfer Demand completed as indicated *[together with this Standby]*[4] to Issuer at the above-stated place for presentation. Upon presentation[5] of a complying demand for transfer, the person identified as the transferee shall become the Beneficiary, whose name and address [*and duly provided bank account information for any requested payment by wire transfer of funds*] shall be substituted for that of the transferor on any demands, requests, or consents then or thereafter required or permitted to be made by Beneficiary.[6] Subject to compliance with applicable law[7][*and receipt of its customary or agreed transfer fees*[8]], Issuer must acknowledge and shall effect the demanded transfer[9] and shall issue its advice of transfer to the [*transferor and*]transferee.[10]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).

[*Communications. Communications other than demands may be made to Issuer by telephone, telefax, or SWIFT message, to the following:* ***[numbers/addresses]***. *Beneficiary requests for amendment of this Standby, including amendment to reflect a change in Beneficiary's address, should be made to Applicant, who may then request Issuer to issue the desired amendment.*]

[Issuer's name]

[signature]
Authorized Signature

Annexed Payment Demand

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby")

The undersigned Beneficiary demands payment of [INSERT CURRENCY/AMOUNT] under the Standby.

Beneficiary states that Applicant is obligated to pay to Beneficiary the amount demanded[, *which amount is due and unpaid*] under[*or in connection with*] the agreement between Beneficiary and Applicant titled **[agreement title]** and dated **[date]**.

[*Beneficiary further states that the proceeds from this demand will be used to satisfy the above-identified obligations and that Beneficiary will account to Applicant for any proceeds that are not so used*.]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].

[Beneficiary's name and address]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE]

Annexed Transfer Demand

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby")

The undersigned Beneficiary demands[11] transfer of drawing rights in their entirety, including rights to demand further payment[, *reduction, cancellation,*] and transfer[12] under the Standby and rights to give or withhold consent to any pending or future amendment or cancellation, to the following person at the following address: [INSERT NAME AND ADDRESS OF THAT PERSON

_____
_____
_____]

[*and with the following bank account for payment by wire transfer of funds to that person* [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF THAT PERSON'S BANK AND NAME AND NUMBER OF THAT PERSON'S ACCOUNT]].

Beneficiary states that the above-identified person is the transferee, from and after the effective date stated below, of all of Beneficiary's rights that are supported by the Standby [*and Beneficiary's related obligations*]under[*or in connection with*] the agreement between Beneficiary and Applicant titled **[agreement title]** and dated **[date]**.[13]

Beneficiary further states that there are no outstanding demands by Beneficiary for any other transfer or for any payment[, *or for any reduction or cancellation*] under the Standby. Beneficiary agrees to make no such demands or requests while this demand is outstanding.

[*Accompanying this demand is the Standby*.][14]

Please effect the demanded transfer [*as of the following effective date:* [INSERT DATE] _____.[15] *Please do so*]by marking and delivering the Standby or by delivering a replacement to the above-identified person as the transferee beneficiary and then notify the undersigned thereof.

[*Also accompanying this demand is Issuer's transfer fee of an amount equal to* ***[percentage amount]****% of the amount of the standby to be transferred but not to exceed* ***[currency/amount]***].

[Beneficiary's name and address]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE][16]

[Before the standby is issued, all text in **[bold]** should be completed, and optional text in [*italics*] should be included or deleted (or redrafted). Text in the annexed demand forms preceded by "INSERT" (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the beneficiary prepares and presents a demand.]

****

This ISP98 Form 4 model standby repeats the text of ISP98 Form 1. It adds standby text and incorporates a model transfer demand form that obligates the issuer to acknowledge a transfer of drawing rights upon receipt of the transfer demand completed and presented by the beneficiary. Like ISP98 Form 1, this Form 4 is intended to be self-contained and, absent special circumstances, useable without extended reference to the text of ISP98.

The endnotes to this standby include alternative and other optional terms of particular relevance to standbys providing for transfer on demand or automatic reduction (including reduction to zero), as well as references to relevant ISP98 rules. See the ISP98 Form 1 endnotes for explanation of wording that is common to ISP98 Forms 1 and 3 and for alternative and optional wording for general terms common to both forms.

These endnotes do not include model wording for a form that an issuer might use when requested to give effect to a transfer that the issuer is not obligated to acknowledge.

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Transfer; succession; and assignment of proceeds. ISP98 Rule 6 (Transfer, Assignment, & Transfer by Operation of Law) provides separate rules for contractual transfer of drawing rights, for transfer of drawing rights to a legal successor, and for assignment of the proceeds of a beneficiary's drawing.

If a standby does not state that it is transferable, then under ISP98 Rule 6.02(a) (When Drawing Rights are Transferable), a request for transfer of the beneficiary's drawing rights, other than from a claimed legal successor, can be processed only as a request for amendment or for cancellation and new issuance.

Under ISP98 Rules 6.11-6.14 (Transfer by Operation of Law and/or applicable law, a legal successor may claim the rights of a transferee beneficiary under an otherwise non-transferable standby. Beneficiaries requiring additional certainty or clarity regarding the status of a legal successor to the beneficiary may wish to include in the standby, e.g., "Issuer undertakes to treat Beneficiary's successor by operation of law as the authorised transferee of Beneficiary against presentation of the additional documents(s) from a public official referred to in ISP98 Rule 6.12, such as a document issued by **[identification of public official]** authorising or appointing the claimed successor as Beneficiary's liquidator, rehabilitator, receiver, or conservator." Separately from the terms of the standby and ISP98, a legal successor may be entitled by applicable law to sign demands and otherwise act as the named beneficiary. The ISP98 rules for legal successors address those successors that would sign as a named successor and not as the named beneficiary.

The word "assignable" does not mean "transferable" for purposes of ISP98. See ISP98 Rule 1.10(c)(ii) (Redundant or Otherwise Undesirable Terms) and ISP98 Rules 6.06-6.10 (Acknowledgement of Assignment of Proceeds). In general, ISP98 Rule 6 protects applicants as well as issuers against presentations made by a third party but protects only issuers against requests to pay to a third party part or all of the proceeds resulting from a complying presentation made by the beneficiary.

Ordinarily, requests for assignments of proceeds are made after standby issuance. Issuer acknowledgement of an assignment could be included in a standby, e.g.: "Payment against a complying presentation shall be made at the place for presentation or by wire transfer to a duly requested account of Beneficiary, except for the following amount: **[currency/amount],** which Beneficiary has irrevocably assigned to the following acknowledged assignee of standby proceeds with the following bank account **[name and address of assignee; name, address, and routing number of assignee's bank; and name and number of assignee's account]**. An advice of each such payment shall be sent to Beneficiary's above-stated address."

[2] Permitted transfers. Under ISP98 Rules 6.02(b) (When Drawing Rights are Transferable), if a standby states that it is transferable, without more, then drawing rights under it may be transferred by the beneficiary in their entirety (not partially). Successive transfers of entire rights under a transferable standby are allowed in ISP98 Rule 6.02(b)(1) (When Drawing Rights are Transferable). All such transfers, however, require that the issuer agrees and effects the transfer requested by the beneficiary under the largely discretionary provisions of ISP98 Rules 6.01-6.05 (Transfer of Drawing Rights). Issuers regularly do so against the beneficiary's payment of a fee and completion of the issuer's own forms, which may differ significantly from the annexed model form of transfer demand in this ISP98 Form 4.

[3] Transfer by beneficiary demand. If a beneficiary requires certainty that its request for transfer will be effected, then the standby should state that the issuer must effect transfer against presentation of a specified document. ISP98 Form 4 so provides and incorporates an annexed model form of transfer demand that makes it unnecessary for the beneficiary to rely on transfer at the discretion of the issuer under ISP98 Rule 6.03 (Conditions to Transfer).

[4] Presentation of standby. This form, like most standbys, does not require presentation of the standby with a payment demand. If, however, a standby requires presentation of the standby with any payment demand, then its presentation should be required with any transfer demand. Its presentation with any transfer demand should also be required if transfer is to be evidenced by the issuer's marking the standby and delivering it to the transferee beneficiary. Its presentation might also be required to indicate that the transfer demand is authentic. See ISP98 Form 1, endnote 9 for an extended discussion of requirements for the presentation of the original standby.

[5] Effective date of transfer. It is generally desirable to clarify and coordinate the effective date of a transfer of drawing rights in their entirety with the effective date of transfer of the underlying obligations supported by the standby. This coordination may be accomplished by changing the model standby text from "Upon presentation of a complying demand for transfer…" to "Upon presentation of, or any later effective transfer date stated in, a complying transfer demand…." The standby should not impose any non-documentary condition that would require the issuer to determine whether or when the underlying obligations were transferred.

[6] Transferee as substituted beneficiary. A transfer of drawing rights in their entirety includes a beneficiary's rights to demand any permitted further transfer or consent to any pending or future amendment or cancellation of the standby. Accordingly, any demand, statement, or other required document to be presented under a transferable standby must bear the name of the transferee rather than of the transferor. See ISP Rule 6.04 (Effect of Transfer on Required Documents). If a transfer of less than the entire rights of the beneficiary is contemplated or if rights exercised before transfer by the transferor are to be transferred, or if both the transferee and transferor intend to have veto rights over past or future amendments to the standby, then the transfer term and the annexed form of transfer demand in this ISP98 Form 4 should be revised to expressly re-allocate any beneficiary rights that are to be recognized by the issuer.

[7] Compliance with law. Processing a transfer request or demand includes checking the transferee's name and other information against applicable sanctions' lists. See ISP98 Form 1, endnote 19, on sovereign compulsion and sanctions' clauses.

[8] Issuer's transfer fee. Issuers expect to receive a fee for processing a transfer request or demand. This optional text in this ISP98 Form 4 addresses that expectation, and the annexed form of transfer demand includes optional text that more precisely states the amount of the transfer fee. They would be unnecessary if the issuer relied solely on the applicant to pay transfer fees.

[9] Mandatory transfer. Because this standby form provides for transfer by demand, it includes an undertaking that the issuer "must" give effect to a complying demand for transfer. Because effecting transfer is mandatory, the issuer's undertaking to effect a demanded transfer should state any conditions other than presentation of a complying transfer demand. The issuer may prefer to include those conditions in the transfer term in the standby even if they are included in the text of the required transfer demand form.

[10] Advice of transfer. Because this standby form provides for mandatory transfer, it includes an

undertaking by the issuer to give effect to a complying transfer demand by issuing an advice of transfer that documents the transferee beneficiary's rights under the standby.

[11] Annexed transfer demand. The annexed model form of demand for transfer is called a "demand" for the sake of clarity. This ISP98 Form 4 standby obligates the issuer to effect transfer against receipt of a specified document. Accordingly, this is not a model form of transfer request to be used with a standby that is "transferable" but allows the issuer to exercise its discretion as to how and whether to recognize a requested transfer under ISP98 Rules 6-01-6.05 (Transfer of Drawing Rights) or under ISP98 Rules 6.11-6.14 (Transfer by Operation of Law).

[12] Rights transferred. Under ISP98 Rule 6.02(b)(i) (When Drawing Rights are Transferable), it is unnecessary for a transferable standby to provide expressly for successive transfers or for transfer of any particular beneficiary rights, such as the right to demand reduction or to consent (or not) to a pending or future amendment.

[13] Statement of underlying transfer of supported obligations. A standby that undertakes to effect transfer against the presentation of a demand or other documents is typically underpinned by an agreement that obligates the beneficiary to the applicant to demand a transfer of drawing rights only when the underlying contractual obligations are being rightfully and fully transferred. In their negotiation of their underlying contractual obligations and the related standby terms, the contracting parties may require a more specific beneficiary statement regarding the basis for a demanded transfer.

[14] Standby enclosed. If the text of a standby requires presentation of the standby (or any beneficiary statement as to the existence and status of any amendments, demands, or other activity affecting the standby), then the annexed form of demand for transfer should address those requirements. See endnote 4 to this ISP98 Form 4 and endnote 9 to Form 1.

[15] Postponed effective date. This optional wording addresses the possibility that the effective date of a transfer is to occur after presentation of the beneficiary's demand for transfer.

[16] Authentication. This model form of annexed transfer demand requires the same level of authentication as the model form of payment demand. ISP98 Rule 7 (Cancellation) lists additional conditions that the beneficiary, applicant, or issuer might wish to consider to deter unauthorized transfer demands.

[*IIBLP as of 31 March 2012*]

ISP98 Form 5
Simplified Demand Only Standby*

[name and address of beneficiary] **[date of issuance]**

On the application of **[name and address of applicant]**, we, **[name and address of issuer]**, issue in your favour this standby letter of credit No. **[number]** subject to the International Standby Practices 1998 (ISP98) (ICC Publication No. 590)[1] in the amount of **[currency/amount]**, payable[2] against presentation of your demand[3] to us at **[address of place for presentation]**[4] on or before **[date]**.[5]

[issuer's name]

[signature]
Authorized Signature

[Before the standby is issued, all text in **[bold]** should be completed.]

****

This is a form of simplified demand only standby. It relies on the incorporated ISP98 Rules to fill gaps, particularly as to the form of demand required to obtain honour. The endnotes to this form identify the gap-filling Rules.

This ISP98 Form 5 is intended to show that a simplified form of standby calling for a demand only is feasible. See ISP98 Form 1 (Model Standby Incorporating Annexed Form of Payment Demand (with Statement) for a more self-contained model standby with more extensive endnotes.

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Incorporation of ISP98. ISP98 Rule 1.06 provides that an ISP98 standby is "an irrevocable, independent, documentary, and binding undertaking when issued and need not so state". It is thus unnecessary for an ISP98 standby to recite that it is enforceable without regard to the validity of any claim of performance or non-performance in the underlying transaction. It is unnecessary to add a recital (including an "integration" or "merger" clause) that would deny or limit the effect of any document or other matter mentioned in the standby or of any negotiations leading up to or following standby

issuance. Such clauses and recitals risk limiting the various ISP98 rules that provide for the standby's independence.

[2] Honour by payment. ISP98 Rules 2.01 (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) and 5.01 (Timely Notice of Dishonour) provide that an issuer undertakes to honour a complying presentation and that an issuer has at least three, but not more than seven, business days after presentation either to pay or send a notice of dishonour.

[3] Presentation of demand. This ISP98 Form 5 requires presentation of a demand but, unlike ISP98 Forms 1-4, this simplified standby does not describe or annex a required form of demand. ISP98 Rule 4.16 (Demand for Payment) requires that a demand for payment identify the standby as indicated in Rule 3.03 (Identification of Standby), state the amount demanded, be from the beneficiary and directed to the issuer, and be dated and signed as indicated in Rule 4.16 (Demand for Payment). ISP98 does not require that a demand be in the form of a "draft" or "bill of exchange" or include any other statement or be accompanied by any other document. ISP98 Rule 3.08 (Partial Drawing and Multiple Presentations; Amount of Drawings) provides that a beneficiary has the right to present partial and multiple demands. A beneficiary preparing a demand under this simplified form of standby could simplify the wording in the annexed demand form in ISP98 Form 1.

[4] Complying presentation. To the extent that a standby that fails to state where, how, and to whom presentation must be made, ISP98 Rules 3.04 (Where and to Whom Complying Presentation Made) and 3.06 (Complying Medium of Presentation) apply. Those rules generally require physical presentation of a paper document to the issuer but allow a beneficiary that is a bank or SWIFT participant to present a demand using SWIFT or other similar authenticated means.

[5] Expiration. Standbys must provide for their termination under ISP98 Rule 9.01 (Duration of Standby) and likely also under applicable commercial law and banking regulations. This form of standby is based on the common practice of stating a specific calendar date as the expiration date, i.e., the latest date for presentation. ISP98 Rules 3.13 (Expiration Date on a Non-Business Day) and 3.14 (Closure on a Business Day and Authorization of Another Reasonable Place for Presentation) provide for an extension if the place for presentation is closed on that date.

[*IIBLP as of 31 March 2012*]

ISP98 Form 6
Model Counter Standby with Annexed Form of Local Bank Undertaking*

[name and address of local bank beneficiary] **[date of issuance]**

At the request and for the account of **[name and address of applicant]** ("Applicant"),[1] we **[name and address of issuer at place of issuance]** ("Issuer") issue this irrevocable standby letter of credit number **[reference number]** ("Counter Standby") in favour of **[name and address of beneficiary]** ("Beneficiary")[2] in the maximum aggregate amount of **[currency/amount].**

This is a counter standby[3] letter of credit supporting Beneficiary's issuance of its separate [*local bank*] undertaking[4] in the form of the Annexed Local Undertaking[5][*to be issued on or before **[date]***].[6]

Issuer undertakes to Beneficiary to pay Beneficiary's demand that includes[7] Beneficiary's statement[8] that Beneficiary issued its Local Undertaking as provided in the Counter Standby and has received [*and honoured*] a complying demand under its Local Undertaking in the amount hereby demanded from Issuer, if Beneficiary's demand is presented to Issuer on or before the expiration date either as an originally signed paper document at Issuer's above-stated address or as an authenticated SWIFT message sent to Issuer's SWIFT address **[SWIFT code]** from Beneficiary's SWIFT address **[SWIFT code]**.[9]

The expiration date of this Counter Standby is **[date]**.[10]

[*Payment against a complying presentation shall be made within three business days after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary.*]

This Counter Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).[11]

[Issuer's name]

__[signature]_____
Authorized Signature

Annexed Local Undertaking

[INSERT DATE]

[name and address of person indicated in counter standby as the intended local beneficiary of the local bank undertaking]

On the application of **[counter standby applicant's name and address]**, **[counter standby issuer's name and address]** has issued to us a standby letter of credit supporting our issuance of this undertaking to you.

We, **[name and address of local bank]**, issue in your favour our **[***standby letter of credit***] [***guarantee***] [***undertaking***]** No. [INSERT REFERENCE NUMBER] in the amount of **[currency/amount]** payable against your demand for payment presented on or before **[date]** to us at **[address of place for presentation]**, that identifies this undertaking, states the amount demanded, and includes your certificate that the amount demanded is due to you from **[counter standby applicant's name]** under [*numbered agreement sections or identified obligations to perform bid, bonding, delivery, warranty or other obligation or to account for advance payments received of*] your agreement titled **[agreement title]** and dated **[date]**.[12]

Our undertaking is subject to the International Standby Practices 1998 (ISP98) (ICC Publication No. 590).[13]

[local bank issuer's name]

[INSERT ORIGINAL SIGNATURE]
Authorized Signature

[Before the counter standby with annexed form of local bank undertaking is issued, all text in **[bold]** should be completed, and optional text in [*italics*] should be included or deleted (or redrafted). All text preceded by "INSERT" (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the annexed local undertaking is prepared and issued.]

****

This ISP98 Form 6 is a model form for a commonly used type of standby. As described in the Preface to ISP98, a "Counter Standby" supports the issuance of a separate standby or other undertaking by the beneficiary of the counter standby. The beneficiary of a counter-standby is typically another bank familiar with acting as a standby beneficiary and issuer and doing so by receiving and sending authenticated SWIFT messages as well as paper documents. Most counter standbys are issued as inter-bank authenticated SWIFT messages, and this ISP98 Form 6 could b adapted to a SWIFT message format.

The annexed form of local bank undertaking is also an ISP98 standby, but it could take many other forms. The local undertaking to be annexed to a counter standby should reflect the input of the local bank and local beneficiary, as well as the counter standby issuer and its applicant.

The endnotes to this ISP98 Form 6 refer to ISP98 rules of particular relevance to counter standbys. See the endnotes to ISP98 Form 1 for explanation of wording that is common to ISP98 Forms 6 and 1 and for alternative and optional wording.

A standby that provides for confirmation by another bank serves substantially the same purpose as a counter standby that supports another bank's local undertaking. Either type of standby can be worded to reduce or expand the differences between the two under ISP98. See the ISP98 Form 7 Model Standby Providing for Confirmation for an alternative to this Form 6 Model Counter Standby with Annexed Form of Local Bank Undertaking.

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[1] Applicant. The applicant for a counter standby typically has a "bid", "performance", "advance payment", or other such obligation to a distant contracting party that must be supported by a local bank standby, guarantee, bond, or other undertaking. The applicant for the counter standby applies to its bank for issuance of a counter standby in order to meet the requirements of a local bank for an assured right of incoming payment in case the local bank must honour its local undertaking.

[2] Beneficiary. The beneficiary named in a counter standby (like the issuer of the counter standby) is typically a bank that, on the basis of the counter standby, issues its own local bank standby, guarantee, bond, or other undertaking. The references in this model form and endnotes to "local bank" and "local bank undertaking" (and to "local undertaking" and "local beneficiary") are for convenience in distinguishing the two different undertakings and the two different sets of issuers and beneficiaries involved in counter standby practice. The beneficiary of the counter standby need not be a bank. Its status as a non-bank might affect the nature of its local undertaking, but should not affect the independence of the counter standby under ISP98.

[3] Counter standby name. While this model form is named a "counter standby", the name is not determinative of its character as an undertaking within the scope of ISP98 or as an independent undertaking under applicable law. As noted in the ISP98 Preface, categorizing standbys based on the type of underlying transaction does not affect the application of the ISP98 Rules.

[4] Request for local bank undertaking. This counter standby form assumes, but does not itself request, issuance by the beneficiary of a separate undertaking. ISP98 Rule 8.02 (Charges for Fees and Costs) obligates an issuer to pay the reasonable and customary fees and expenses of a beneficiary requested by the issuer to issue a separate undertaking, if otherwise unrecovered and unrecoverable. Accordingly, it may be desirable to clarify in the counter standby whether and to what extent the counter standby issuer must pay such

fees and expenses.

ISP98 Rule 4.21(a) (Request to Issue Separate Undertaking) provides that a beneficiary of a counter standby receives no rights "other than its rights to draw under the standby even if the issuer pays a fee to the beneficiary for issuing the separate undertaking."

[5] Form of local bank undertaking. The local bank undertaking may be a standby letter of credit, independent guarantee, dependent guaranty, bond, or contractual promise. This model form of counter standby specifies by annex the type and terms of the local bank undertaking.

[6] Delivery of local undertaking. If the local bank undertaking is to be delivered to the applicant's representative, then details for such delivery (and the effect of non-delivery or return of the local bank undertaking) should be added to the counter standby.

If it is desired that issuance of the counter standby be deferred until the local bank undertaking is issued, then ISP98 Rules 2.03 (Conditions to Issuance) and 4.11 (Non-Documentary Terms or Conditions) should be consulted. These same rules should be consulted if it is desired that issuance of the counter standby be deferred until an advance payment is actually made to the applicant for the counter standby.

[7] Unstated requirements for demand. The word "includes" signals that there are unstated requirements for a complying demand, i.e., the demand must also include a date and identification of the counter standby. See ISP98 Form 1, endnote 10, and ISP98 Form 5, endnote 3.

[8] Statements. Beneficiary statements included in a counter standby form of demand are sometimes limited to the beneficiary's issuance of the requested local bank undertaking, receipt of a complying demand for payment thereunder, and incurrence of an absolute obligation to pay. Beneficiary statements under a counter standby sometimes also recite that payment has been made under the local bank undertaking (in which case the counter standby may provide for same day payment or payment with value from the date the beneficiary states that it funded its local undertaking).

If a counter standby requires presentation of (a copy of) the local bank undertaking issued or of the demand received under the local bank undertaking, then the standby text should state whether and how such documents are to be examined by the counter standby issuer. If a counter standby does not require their presentation but such documents are nonetheless presented under the counter standby, then ISP98 Rule 4.21(c) (Request to Issue Separate Undertaking) provides that the issuer of the counter standby "shall disregard their compliance or consistency with the standby, with the beneficiary's demand under the standby, or with the beneficiary's separate undertaking" and may return or forward any such documents.

Beneficiary statements typically are made to the issuer of the counter standby (bank to bank) and not to the applicant for the counter standby. They typically do not include

representations as to whether the applicant is obligated in any underlying transaction. In this regard it is assumed that the documentation for the transaction underlying a local bank undertaking will adequately establish the applicant's contractual obligations to provide a local bank undertaking and the applicant's contractual rights and remedies in case of a disputed drawing or a disputed use of proceeds from a drawing.

If a counter standby provides that it may be it terminated on advance notice given by the issuer, then the required form of beneficiary statement should permit the local bank beneficiary to demand payment under the counter standby and hold the proceeds as security against a possible future drawing under its local bank undertaking. See ISP98 Form 2 for model wording and alternative and optional wording for automatic extension and for demand following a notice of non-extension.

[9] Presentation via SWIFT. This counter standby form expressly permits presentation of a demand via authenticated inter-bank SWIFT message. ISP98 Rule 3.06 (Complying Medium of Presentation) permits such presentations without express wording in the standby as between SWIFT bank members.

[10] Expiration. The terms of a counter standby and of a local bank undertaking should be drafted in light of the terms of the underlying obligation and should address the possibility that the counter standby or the local bank undertaking or both may expire prematurely relative to the underlying transaction.

ISP98 Rule 3.09 (Extend or Pay), while not specific to counter standbys, addresses a practice that is particularly associated with demands made under counter standbys. Typically the beneficiary of a counter standby issues a local undertaking that will expire several days before the counter standby will expire. If the counter standby issuer does not timely affirmatively extend its counter standby, then the local bank beneficiary of the counter standby may make a so-called "extend or pay" demand before the counter standby will expire. Under this ISP98 rule, an issuer examines any "extend or pay" demand for compliance as a demand for payment and, whether or not the demand complies, treats the demand as separately requesting an amendment extending the counter standby. See ISP98 Form 2, endnote 13.

Some counter standbys provide for automatic extension with a right to terminate a future automatic extension by giving advance notice. In such cases particularly, the counter standby and local bank undertaking should be aligned so that the local bank beneficiary may demand payment whenever the counter standby is about to expire before the local bank undertaking will expire. See endnote 8 to this ISP98 Form 6

[11] Choice of law; choice of forum. A counter standby may usefully include a choice-of-law and choice-of-forum clause. A choice of law or forum or both in a counter standby would apply to the standby issuer's obligations and not to the obligations of the local bank beneficiary under its separate undertaking. See ISP98 Form 1, endnote 19, on law/forum clauses, including the availability of arbitration under the ICLOCA rules.

[12] Certificate. The certificate may be included in the demand made under this form of local bank undertaking. If in separate documents, the certificate, as well as the demand, should be dated and signed. See ISP98 Rules 4.07 (Required Signature on a Document), 4.12 (Formality of Statements in Documents), 4.16 (Demand for Payment), and 4.17 (Statement of Default or Other Drawing Event).

[13] Incorporation of ISP98. This form of local bank undertaking states that it is subject to ISP98. ISP98 is available for use in any country that will enforce letters of credit and demand guarantees independently of the issuer's reimbursement rights and the beneficiary's rights in the underlying transaction.

Issuance of a counter standby subject to ISP98 does not require that the local bank undertaking also be issued subject to ISP98 (or by a bank). Unless an ISP98 counter standby otherwise states, the local bank undertaking could be issued as an independent undertaking subject to ISP98 or to other rules or to no rules, or it could be issued as a dependent undertaking. Similarly, the local bank undertaking could be issued subject to law other than the law applicable to an ISP98 counter standby or to any underlying transaction.

[*IIBLP as of 31 March 2012*]

ISP98 Form 7
Model Standby Requiring Confirmation*

[name and address of beneficiary or nominated person or both] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]** ("Applicant"), we **[name and address of issuer at place of issuance]** ("Issuer") issue this irrevocable standby letter of credit number **[reference number]** ("Standby") in favour of **[name and address of beneficiary]** ("Beneficiary") in the maximum aggregate amount of **[currency/amount]**.

Expiration. The expiration date of this Standby is **[date]**.

Nomination. Issuer nominates **[name and address of nominated person]** to advise[1] and confirm[2] this Standby.

Confirmation required.[3] If the nominated person does not issue its confirmation on or before **[date]**,[4] then this Standby shall be automatically cancelled.[5]

Presentations. If the nominated person issues its confirmation to Beneficiary, then all presentations must be made to the nominated person ("Confirmer") at a place of presentation stated in its confirmation ("Confirmation").[6] Presentations by Beneficiary to Issuer shall not affect Issuer's obligations under this Standby and may be disregarded by Issuer, whether or not this Standby is confirmed.[7]

Undertaking.[8] Issuer undertakes to Beneficiary and to Confirmer that Issuer shall honour this Standby by reimbursing Confirmer for Confirmer's payment[*if Confirmer rightfully honours a presentation made under its Confirmation,*][9] if the document(s) presented to Confirmer on or before the above-stated expiration date[10] are promptly forwarded[11] by Confirmer to Issuer for examination by Issuer,[12] and if the forwarded documents include the following: Beneficiary's demand that (i) identifies this Standby (by the name and address of the Issuer and of the Applicant and reference number for this Standby, as shown above) and identifies the Confirmation (by the name and address of the Confirmer and reference number for the Confirmation), (ii) is dated and signed by Beneficiary, and (iii) states that Applicant is obligated to pay to Beneficiary the amount demanded under the agreement between Beneficiary and Applicant titled [**agreement title**] and dated [**date**].[13] This is Issuer's only undertaking.[14] Issuer disclaims any obligation based on Confirmer's dishonour of its obligations.[15]

[*Charges. Beneficiary shall be solely responsible for payment of Confirmer's fees and charges under or in connection with its Confirmation. Issuer disclaims for itself and Applicant any responsibility for Confirmer's fees, costs, or other charges under ISP98 Rule 8.02 or otherwise.*][16]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).

[*Communications. Communications other than documents forwarded by Confirmer may be made to Issuer by telephone, telefax, or SWIFT message, to the following:* ***[numbers/addresses]***. *Confirmer/nominated person should promptly communicate to Issuer whether, when, and how it advises and confirms this Standby. Beneficiary requests for amendment of this Standby, including amendment to reflect a change in Beneficiary's address, should be made to Applicant, who may then request Issuer to issue the desired amendment subject to Confirmer's consent.*][17]

[Issuer's name]

[signature]
Authorized Signature

[Before the standby is issued, all text in **[bold]** should be completed and optional text in [*italics*] should be included or deleted (or redrafted).]

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This ISP98 Form 7 model standby assumes that the beneficiary has requested the applicant to arrange for confirmation by a confirmer, typically a bank, that is closer and better known to the beneficiary than the standby issuer. Accordingly, this form is focused on inducing the issuance of the desired confirmation. It requires that the confirmer timely issue a confirmation and that the beneficiary present to the confirmer only. It provides for payment by the standby issuer to the confirmer only.

This ISP98 Form 7 model standby authorizes issuance of the ISP98 Form 8 model confirmation.

This ISP98 Form 7 model standby may be usefully compared and contrasted, both functionally and structurally, to the ISP98 Form 6 model counter standby that supports issuance of a local bank undertaking.

The endnotes to this form include alternative and other optional terms of particular relevance to standbys that provide for confirmation, as well as references to relevant ISP98 rules. See the ISP98 Form 1 model standby endnotes for explanation of wording that is common to ISP98 Forms 1 and 7 and for alternative and optional wording.

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit.

ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Nomination to advise. A standby that nominates a person to confirm typically also nominates that person to advise the standby. As to the limited significance of advising a standby, see ISP98 Rules 2.05 (Advice of Standby or Amendment) and 2.07 (Routing of Amendments).

[2] Nomination to confirm. Under ISP98 Rule 1.09(a) (Definitions) a "confirmer" must be nominated by the standby issuer, and under Rule 1.11(c) (Interpretation of these Rules) a confirmation is generally treated as a separate standby issued by the confirmer for the account of the standby issuer.

[3] Confirmation required. This ISP98 Form 7 is based on an underlying agreement between the applicant and the beneficiary that the applicant will arrange for a standby to be either issued or confirmed by a beneficiary-approved bank. Where the applicant applies for a standby to be confirmed by a beneficiary-approved bank, the focus is on the beneficiary's satisfaction with the confirmation and on the confirmer's satisfaction with the standby. In this context, a standby that nominates a beneficiary-approved confirmer but is not confirmed fails to satisfy the underlying agreement and likely requires a substantial change in the underlying agreement or standby terms or both.

If, however, the standby is to be useable even though no confirmation is issued, then the text of the standby should be redrafted. In particular, the issuer's undertaking should be redrafted to substitute, e.g.: "If the person nominated to confirm does not issue its confirmation, then Issuer undertakes to Beneficiary to pay against presentation to Issuer on or before the expiration date at the following place for presentation: **[address of place of presentation to Issuer]** of Beneficiary's demand that (i) identifies this Standby (by the name and address of the Issuer and of the Applicant and reference number for this Standby, as shown above), (ii) is dated and signed by Beneficiary, (iii) states that Applicant is obligated to pay to Beneficiary the amount demanded under the agreement between Beneficiary and Applicant titled [**agreement title**] and dated [**date**], and (iv) states that no confirmation of this Standby was issued[*despite Beneficiary's tender of payment of confirmation fees and charges*]."

[4] Timely confirmation. Confirmation may require time-consuming internal credit and country risk approvals and sanction clearance checks. Accordingly, unless confirmation has been pre-arranged, this period might be appropriately set at 30 calendar days. As a practical matter, the person nominated to confirm will require that the standby be issued before it is confirmed, and the issuer will charge fees for its exposure before as well as after the standby is confirmed.

The fact that a confirmation is or is not timely issued is an effective standby condition, whether or not the issuer receives a written notice thereof. It is not a non-documentary condition under ISP98 Rule 4.11(c)(ii) (Non-Documentary Terms or Conditions). In this regard, other ISP98

rules permit or require an issuer to treat a confirmer's operations affecting the standby as within the issuer's operations. See endnote 6 on ISP98 Rule 2.01(d)(iii) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary), which provides for an issuer's obligation for wrongful dishonor of a presentation made to the confirmer.

[5] Automatic cancellation. This model form states that the standby is issued and, if not timely confirmed, then it is automatically cancelled. For the reasons indicated in the preceding endnote, it would not be practical to condition standby issuance on confirmation issuance. See ISP98 Rules 2.03 (Conditions to Issuance) and 2.06(a) (When an Amendment is Authorised and Binding).

[6] Presentations to confirmer. ISP98 Rule 2.01(a) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) obligates an issuer to honour a complying presentation made to the issuer. ISP98 Rule 3.04 (Where and to Whom Complying Presentation Made) provides for presentation to the issuer of a standby, whether or not confirmed. These rules are intended to maximize a beneficiary's rights against the issuer. However, these rules also maximize the burdens and risks of the issuer of a confirmed standby. In this regard, because most standbys require presentation of beneficiary prepared documents that have no intrinsic value and are easily duplicated, there are risks of duplicate presentation under standbys that permit presentation at more than one place. Accordingly, the effects of these rules are frequently and appropriately limited in the text of the standby. This form of standby expressly requires that all presentations be made to the confirmer.

An ISP98 standby that permits presentation to a confirmer thereby obligates the issuer to perform the confirmer's obligations if the confirmer wrongfully dishonours. This standby form, which permits presentation to the confirmer, expressly disclaims that obligation. See endnote 15.

[7] No presentation to issuer. This form of standby expressly disclaims issuer responsibility for any attempted presentation by the beneficiary to the issuer, even if the standby is not confirmed. This disclaimer is consistent with treating the standby as cancelled if not confirmed and is included for the avoidance of doubt.

Endnotes 3 and 15 address the possibility of obligating the issuer directly to the beneficiary, where the standby is not confirmed and also in certain circumstances where the standby is confirmed.

[8] Undertaking to honour/reimburse. The issuer's undertaking in this standby form includes rightful honour of the confirmation as an optional condition to payment under the standby. The wording in this clause is based on ISP98 Rules 8.01(a)(ii) (Right to Reimbursement) and 1.11(c)(1) (Interpretation of these Rules). Under those rules an issuer's obligation to reimburse a confirmer is treated like an applicant's obligation to reimburse an issuer. The issuer's undertaking in this standby form also includes conditions to payment under the standby based on the confirmer's forwarding the documents specified in the standby for examination under the ISP98 rules that apply to a presentation to an issuer, i.e., ISP98 Rules 4 (Examination) and 5

(Notice, Preclusion, and Disposition of Documents).

Although largely theoretical, there are differences between reimbursing a confirmer and honouring a confirmer's presentation. E.g., the letter of credit independence principle may be somewhat differently applied. A confirmer claiming reimbursement may be treated for some limited purposes as an agent of the issuer or as an agent of the beneficiary. Whether a confirmer rightfully honoured its confirmation may depend on the law where the confirmer acted and not on the law governing the standby issuer. Accordingly, the concerned parties may wish to include both or to exclude or disclaim one or another of these combined undertakings of the issuer to reimburse and to honour.

[9] Confirmer's rightful honour. If a standby provides for paying a confirmer that rightfully honours its confirmation, without further conditions, then the standby issuer may wish to clarify with the applicant that the issuer is entitled to rely on the confirmer's claim of rightful honour. A standby may so provide simply by failing to disclaim a confirmer's ISP98 undertaking in ISP98 Rule 8.01(a)(ii) (Right to Reimbursement), which provides that rightful honour of a confirmation obligates the issuer to reimburse. (This ISP98 Form 7 standby includes additional conditions that limit the issuer's obligations to reimburse/honour, e.g., the forwarding of specified documents to the issuer.)

[10] Expiration with automatic extension. If the standby is to provide for automatic extension of the expiration date or the like, then ISP98 Rule 2.07 (Routing of Amendments) and ISP98 Form 2 should be consulted (and the form of confirmation to be issued should be drafted to give the confirmer time to act in parallel with the issuer, e.g., to send an effective notice of non-extension of the confirmation.)

[11] Prompt forwarding. A confirmer may receive a presentation on the expiration date, thereafter examine the presentation and decide to honour, and thereafter forward the documents to the issuer. This form of standby and ISP98 leave to applicable standard practice determinations as to whether a particular forwarding is "prompt" or how long after the expiration date an issuer may expect a claim for reimbursement or actual receipt of forwarded documents. The applicable standard practice mentioned in ISP98 Rule 1.11(a) (Interpretation of these Rules) includes the practice of issuers and nominated banks under commercial letters of credit that provide that they are available at or expire at the counters of a nominated bank.

A standby may instead require that the documents be forwarded to, or received by, the issuer within a fixed time period. If so, the parties should consider the effect of automatic extension under ISP98 Rules 3.13 or 3.14 (CLOSURE ON EXPIRY DATE). In this regard, the beneficiary under this form of standby is expected to rely on the place of presentation and the expiration date stated in the confirmation, leaving the confirmer with any risks resulting from differences in those terms as between the confirmation and the standby.

[12] Issuer examination of documents. This optional text clarifies that reimbursement is subject to the issuer's examination of the forwarded documents under ISP98 Rules 4 (Examination) and 5

(Notice, Preclusion, and Disposition of Documents) to determine whether the confirmer is entitled to reimbursement under the terms and conditions of the standby, including ISP Rule 8 (Reimbursement Obligations). It is intended to avoid possible arguments over the application of ISP98 rules to claims from a confirmer for honour or reimbursement.

To simplify an issuer's response to a confirmer's claim for payment, the standby may add that the forwarded documents must be accompanied by the confirmer's statement that they were timely received and rightfully honoured by the confirmer under a confirmation issued by the confirmer as provided in the standby. See ISP98 Form 6 model counter standby, endnote 8 and related text.

[13] Form of demand and statement. The requirements in a standby for demanding payment from the issuer should be repeated in the confirmation and supplemented by specific information as to the manner, time, and place of presentation to the confirmer. For additional and alternative model texts and forms of beneficiary payment demands and statements, see ISP98 Forms 1-4 and their endnotes.

[14] Interest; advance payment. Because ISP98 does not provide for interest on late honour or reimbursement, any desired provision on issuer liability to pay interest, collection costs, or the like, should be added (or left to applicable law).

If the standby adds an undertaking to pay the confirmer in advance of the issuer's examination of forwarded documents, then it should restate the issuer's refund right under ISP98 Rule 8.03 (Refund of Reimbursement). If payment to the confirmer is to be made by the confirmer's claiming on another bank, then ISP98 Rule 8.04 (Bank-to-Bank Reimbursement) and the standard ICC rules to which it refers should be consulted.

[15] Confirmer's wrongful dishonour. ISP98 Rule 2.01(d)(iii) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) provides that "If the standby permits presentation to the confirmer, then the issuer undertakes also to honour upon the confirmer's wrongful dishonour by performing as if the presentation had been made to the issuer." This rule (like the similar rule obligating confirmers in case of wrongful dishonour by the issuer) is intended to maximize a beneficiary's rights against an issuer and any confirmer. However, these rules also maximize the burdens and risks of the issuer and confirmer by making both responsible for what the other does under their respective obligations to act with independence, promptness, and finality. This form of standby does not restate that type of undertaking and instead expressly disclaims that undertaking to the beneficiary, consistent with the other clauses in ISP98 Form 7 that limit the issuer's obligations to reimbursing the confirmer. This disclaimer covers confirmer dishonour, whether or not wrongful, so as to avoid argument over the scope of the term "wrongful dishonour" in ISP98 Rule 2.01(d)(iii). This disclaimer is consistent with the assumptions in this model form that the beneficiary relies on the confirmer's confirmation and not on the issuer's standby.

If, however, this disclaimer is not wanted, then the standby should restate the undertaking

described in ISP98 Rule 2.01(d)(iii), e.g.: "If Confirmer wrongfully dishonours a presentation made under its Confirmation, then Issuer undertakes to Beneficiary to honour this Standby by paying to Beneficiary the wrongfully dishonoured amount [against a presentation made to Confirmer on or before the expiration date that includes the above stated document(s)]." The bracketed text is intended to avoid argument based on the confirmer's peculiar handling of the presentation to it, notably where the beneficiary's claim of wrongful dishonour by the confirmer is based on confirmer preclusion rather than beneficiary compliance.

This model form and these endnotes to not include alternative wording for a standby that provides for the beneficiary, at its option, to make presentation on either the issuer or the confirmer or for a standby that provides for action against the confirmer only if the standby is wrongfully dishonoured by the issuer. As indicated in prior endnotes, a standby that provides the beneficiary with unlimited rights to present to either the issuer or the confirmer and then to enforce its claims against either or both is problematic for both. It may make both responsible based on facts and law known to, or peculiar to, one but not the other, e.g., closure of a place for presentation. These risks may be mitigated where the issuer and confirmer are affiliated or otherwise familiar with each other's operations. One risk avoidance step may be to include in the standby (and a similar provision in any confirmation) that the issuer and confirmer may exchange information about the confirmed standby without further consent of or notice to the applicant or beneficiary, as well as that any payment made under either immediately reduces the amount available under both. In this regard, ISP98 Rule 4.11(c)(ii) (Non-Documentary Terms or Conditions) facilitates issuer reliance on communications about the standby sent or received by a confirmer.

[16] Responsibility for confirmer charges. ISP98 Rule 8.02 (Charges for Fees and Costs) generally obligates an issuer to a nominated person (and the applicant to the issuer), to pay the customary charges of a confirmer or other nominated person that acts on the nomination, including those that the beneficiary fails to pay. This optional sentence in the standby allocates responsibility to the beneficiary and expressly disclaims any residual responsibility.

[17] Communications. This optional clause (which was adapted from a similar optional clause in ISP98 Form 1) or a variation of it is particularly apt for a standby that provides for confirmation. For further clarification this clause may be expanded to state that the issuer and the person nominated to confirm should promptly advise each other of all communications affecting the standby (or confirmation) that are made between the beneficiary and either the issuer or the person nominated to confirm. See ISP98 Rules 2.05 (Advice of Standby or Amendment), 2.07 (Routing of Amendments, and 4.11 (Non-Documentary Terms and Conditions).

[*IIBLP as of 31 March 2012*]

ISP98 Form 8
Model Confirmation of Standby*

[name and address of beneficiary as stated in standby] **[date of issuance]**

Issuance. We **[name and address of confirmer at place of issuance]** ("Confirmer") issue this irrevocable confirmation number **[reference number]** ("Confirmation") in favour of **[name and address of beneficiary]** ("Beneficiary") in the maximum aggregate amount of **[currency/amount]**. Confirmer is nominated to issue this Confirmation[1] under standby letter of credit number **[reference number] ("Standby")** issued by **[name of standby issuer and its address at place of standby issuance]** ("Issuer") on the application of **[name and address of applicant]** ("Applicant").[2]

Undertaking. Confirmer undertakes to Beneficiary[3] to pay Beneficiary's demand for payment in the currency and for an amount available under this Confirmation that (i) identifies this Confirmation (by the name and address of the Confirmer and reference number for this Confirmation, as shown above) and identifies the Standby (by the name and address of the Issuer and of the Applicant and reference number for the Standby, as shown above), (ii) is presented to Confirmer at the following place for presentation to Confirmer: **[address of place for presentation]**, on or before the expiration date, (iii) is dated and signed by Beneficiary, and (iv) states that Applicant is obligated to pay to Beneficiary the amount demanded under the agreement between Beneficiary and Applicant titled [**agreement title**] and dated [**date**].[4]

Expiration. The expiration date of this Confirmation is **[date]**.

Presentations only to Confirmer. Confirmer's undertakings to Beneficiary are limited to presentations made to Confirmer under this Confirmation. Confirmer disclaims responsibility under ISP98 Rule 2.01 or otherwise for any presentation Beneficiary makes to Issuer.[5]

Effect of presentations to Issuer. All of Confirmer's obligations under this Confirmation shall terminate automatically upon Beneficiary's making a presentation to Issuer under the Standby unless such presentation is made (i) through Confirmer or otherwise with Confirmer's express consent or (ii) to enforce a presentation wrongfully dishonoured by Confirmer.[6]

Confirmer's fees. [*This Confirmation shall be automatically cancelled on **[date]** if Confirmer has not received before that date Beneficiary's payment of Confirmer's fees and charges for issuing this Confirmation, as follows: **[currency/amount]**, and either payment or satisfactory assurance of payment of Confirmer's other fees and charges in connection with this Confirmation, as follows: **[description of other fees and charges]**.*][7]

ISP98. This Confirmation is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).[8]

Communications. [*Communications to Confirmer about this Confirmation other than demands may be made by telephone, telefax, or SWIFT message, to the following:* ***[numbers/addresses]***. *Beneficiary requests for amendment of this Confirmation, including amendment to reflect a change in Beneficiary's address, should be made to the Issuer's Applicant, who may then request issuance of the desired amendment of the Standby and this Confirmation.*]

[Confirmer's name]

[signature]
Authorized Signature

[Before the confirmation is issued, all text in **[bold]** should be completed and optional text in [*italics*] should be included or deleted (or redrafted).]

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This ISP98 Form 8 model confirmation is intended to be used to confirm an ISP98 Form 7 model standby. It is intended to be self-contained, rather than a short advice in which the confirmer adds its confirmation to a standby that is attached to or reproduced in the confirmer's advice. Like ISP98 Form 7, this form also assumes that the beneficiary intends to rely on and use the confirmation and not the standby.

This confirmation form is based on the ISP98 Form 1 standby, generally substituting "Confirmer" for "Issuer" and "Confirmation" for "Standby" and omitting most of the optional clauses. Like ISP98 Form 7, ISP98 Form 8 describes in the text what documents must be presented rather than attaching a form of demand.

The endnotes to this form include alternative and other optional terms of particular relevance to confirmations, as well as references to relevant ISP98 rules. See ISP98 Form 1, including endnotes, for explanation of wording that is common to ISP98 Forms 8 and 1 and for alternative and optional wording that may be adapted to a confirmation. See also ISP98 Form 7, including endnotes, for explanation of wording in this Form 8 that is determined by the text of the standby to be confirmed or that is common to both forms.

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

[1] Nomination. ISP98 Rule 1.09 (Defined Terms) defines "confirmer" as one who adds its confirmation on the nomination of the issuer. A nomination to confirm should be stated in the Standby and, preferably, referenced in the Confirmation so as to clarify in both undertakings the Confirmer's status as a confirmer. This confirmation form, including these endnotes, do not address issues that may arise where a purported confirmer (sometimes referred to as a "silent confirmer") has not been nominated in the standby to add its confirmation.

[2] Identification of Standby. A confirmation should state the confirmer's separate reference number for the confirmation and also state the reference number and other identifying information for the standby, including identification of the applicant for the standby. In this regard, ISP98 Rule 1.11(c)(i) (Interpretation of these Rules) treats the standby issuer as the confirmer's applicant.

[3] Confirmer's undertaking. A confirmer is a person that is nominated by the issuer of a standby to add its confirmation and that does so by undertaking to honour a complying presentation. See ISP98 Rules 1.09(a) (Definitions), 1.11(c) (Interpretation of these Rules), and 2.01(d) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary).

A confirmation may incorporate, rather than restate, the terms and conditions of the issuer's obligations under the standby to which the confirmer has added its confirmation. This model form of confirmation (ISP98 Form 8) restates all of the terms and conditions affecting the confirmer's obligations to the beneficiary. Restatement is common for confirmations of standbys in favor of beneficiaries that insist on confirmation to satisfy requirements for an approved local bank obligor. This model form of confirmation should qualify as a letter of credit undertaking of the confirmer under ISP98 (and likely also under applicable law) whether or not the standby issuer authorized issuance of the confirmation.

[4] Form of demand and statement. The requirements for demanding payment under a confirmation should follow the requirements of the standby, supplemented by specific information as to the manner, time, and place of presentation to the confirmer. For additional and alternative model texts and forms of beneficiary demands and statements, see ISP98 Forms 1-4 and their endnotes.

[5] Confirmer not responsible for presentations to issuer. ISP98 Rule 2.01(d) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) provides that if a confirmation permits presentation to the Issuer, then the confirmer is responsible for the issuer's wrongful dishonour. This rule is intended to maximize a beneficiary's rights against a confirmer. This model confirmation overrides that rule on the assumption that the typical beneficiary intends to use the confirmation and not the standby and is willing to rely solely on the confirmer. Similarly, the typical confirmer will prefer to rely solely on its own processing of demands and is unwilling to accept the added uncertainty and risk of remedying the issuer's possible wrongful dishonour of a presentation made directly to the issuer.

[6] Prohibition on circumventing the confirmer. If the required documents consist of a demand and statement prepared and signed solely by the beneficiary, then the beneficiary may easily make multiple contemporaneous presentations. If a beneficiary is permitted to present to the issuer in either the standby or the confirmation, then the confirmer receiving a demand will want to satisfy itself that neither it nor the issuer has received a conflicting demand or other communication from the beneficiary. This involves risk and delay, which the confirmer may refuse to accept. This model confirmation form includes wording intended to deter presentation other than to the confirmer by providing for a forfeiture of the beneficiary's rights against the confirmer. The possibility of presentation on either the confirmer or the issuer affects not just the wording of the confirmation but also the wording of the standby. If a confirmation provides for transfer of drawing rights or other discretionary or automatic amendment of its terms, then even greater attention must be paid to prohibiting or limiting beneficiary requests or demands for action by the standby issuer that might affect the confirmer.

[7] Confirmer's charges. This optional clause assumes that the issuer is not responsible for confirmer charges (see the ISP98 Form 7 model standby optional disclaimer of responsibility for confirmer charges) and that the confirmer has not obtained payment or satisfactory assurances of payment from the beneficiary before issuing its confirmation. If the effect of non-payment is to be non-issuance of the confirmation rather than automatic cancellation, then this confirmation should be differently worded in light of ISP98 Rule 2.03 (Conditions to Issuance).

[8] Applicable practice rules, law, court, arbitration, and sanctions. A confirmation is an independent undertaking. Questions as to where, how, and under what practice rules and law a confirmation may be enforced should be dictated by the confirmation and not by the standby it confirms. A confirmation may be issued subject to ISP98, even though the standby states that it is issued subject to different practice rules or no rules.

A confirmer may desire clarity that its confirmation is subject to the law of the place where its confirmation is issued (or where presentation to the confirmer must be made), and the beneficiary may also want clarity that the confirmer cannot defend dishonour of its confirmation on the basis of the law applicable to the issuer. In this regard, beneficiaries obtain confirmations to avoid the country risk as well as credit risk associated with the issuer. If the standby includes a choice of law or court or arbitration clause or a sanctions clause, particular attention should given to the possible effect or lack of effect of each such clause on the confirmer's obligations. See ISP98 Form 1, endnote 19.

[*IIBLP as of 7 June 2013*]

This ISP98 Form 11.1 Model Government Standby Form is for federal, state, and local governments in the United States to use in updating and improving their required or permitted forms of standby letters of credit that support underlying obligations to the government.

ISP98 Form 11.1 [U.S.]
Model Government Standby Form*

[Before a standby is issued, all text in **[bold]** in any annex as well as in the body of the standby should be completed as indicated, and optional text in [*italics*] should be included or deleted (or redrafted). Text in [ALL CAPITALS UNDERLINED] should be completed as indicated when the beneficiary prepares a demand for presentation.]

Standby Letter of Credit

[name and address of beneficiary][1] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]**[2] ("Applicant"), we **[name and address of issuer at place of issuance]**[3] ("Issuer") issue this irrevocable[4] independent[5] standby letter of credit number **[reference number]** ("Standby") in favor of **[name and address of beneficiary]** ("Beneficiary") in the maximum aggregate amount of USD **[amount]**.[6]

Undertaking. Issuer undertakes to Beneficiary to pay Beneficiary's demand for payment for an amount available[7] under this Standby and in the form of Annex A (Payment Demand)[8] [*or Annex B (Payment Demand after Notice of Non-extension)*][9] completed as indicated[10] and presented[11] to Issuer at the following place for presentation: **[address of place for presentation]**,[12] at or before the close of business[13] on the expiration date.[14]

Overdrawing. If a demand exceeds the amount available, but the presentation otherwise complies, Issuer undertakes to pay the amount available.[15]

Expiration. The expiration date of this Standby is **[specific calendar date, e.g., the date one year after issuance date]**.[16]

Automatic Extension. The expiration date of this Standby shall be automatically extended[17] for successive one-year periods, unless **[30]**[18] or more calendar days before the then current expiration date Issuer gives written notice to Beneficiary that Issuer elects[19] not to extend the expiration date. Issuer's written notice must be sent[20] [*by registered, certified, or priority express mail or nationally recognized overnight courier*] to Beneficiary's above-stated address [*and to the attention of **[office, officer, or other attention party]** or, alternatively, be received by*

Beneficiary's attention party] **[30]** or more calendar days before the then current expiration date. The expiration date is not subject to automatic extension beyond **[specific calendar date, e.g., the date five years after issuance date]**, and any pending automatic one-year extension shall be ineffective beyond that date.[21]

Payment. Payment against a complying presentation shall be made within three business days after presentation [22] at the place for presentation or by wire transfer to a duly requested account of Beneficiary.[23]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).[24]

Issuer's Charges and Fees. Issuer's charges and fees for issuing, amending, or honoring this Standby are for Applicant's account and shall not be deducted from any payment Issuer makes under this Standby. [*Issuer undertakes to Beneficiary to pay the charges and fees of any bank nominated in this Standby to advise [and confirm] this Standby for acting on such nomination.*][25]

[*Communications. Communications other than demands may be made to Issuer in the manner and at the place for presentation and also as follows:* ***[addresses for mailed, couriered, telephone, telefax, or electronic communications]***. *Communications other than for notices of non-extension may be made to Beneficiary at Beneficiary's above-stated address and also as follows:* ***[addresses for mailed, couriered, telephone, telefax, or electronic communications]***.][26]

[Issuer's name]

[signature]
Authorized Signature

Annex A: Payment Demand

[INSERT DATE][27]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby").[28]

The undersigned Beneficiary demands payment of USD [INSERT AMOUNT] under the Standby.

Beneficiary states[29] that Applicant[30] is obligated[31] to pay to Beneficiary the amount demanded as provided in [**the contract, regulation, or other document that identifies the underlying obligations to the government beneficiary]**.[32]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].[33]

[Beneficiary's name and address][34]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE][35]
[INSERT TYPED/PRINTED NAME AND TITLE]

[***Annex B: Payment Demand after Notice of Non-extension***[36]

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. ***[reference number]****, dated* ***[date]****, issued by* ***[Issuer's name]*** *("Standby").*

The undersigned Beneficiary demands payment of USD [INSERT AMOUNT] under the Standby.

Beneficiary states that the Standby is set to expire fewer than ***[30]*** *days from the date hereof because Issuer has given a notice of non-extension of the Standby[, no retraction of the non-extension notice or satisfactory replacement standby has been timely received,]* [37] *and the amount demanded is required to secure the obligations of Applicant as provided in* ***[the contract, regulation or other document that identifies the underlying obligations to the government beneficiary]****.*

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].

[Beneficiary's name and address]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE]]]

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General Comments on ISP98 Form 11.1

Many government agencies require or permit standby letters of credit to be issued in their favor to support a variety of underlying obligations. Many do so under statutes, regulations, contracts, or guidelines that indicate who may issue a standby in favor of the government and what the standby should provide, typically by requiring that the standby be substantially in the form of a standby text set out in the government's regulation or contract. The general comments and endnotes to this ISP98 Form 11.1 refer to such standbys as a "government standby" and to such sources of government standby requirements as a government “regulation” or "contract".

Government regulations and contracts typically require that a standby be either issued or confirmed by a bank acceptable to the government and include the required form of standby and confirmation. Confirmation is a parallel independent undertaking to honor. The IIBLP intends to develop a model government confirmation form based on the acceptability to the government beneficiary of the confirmer (rather than the acceptability of the standby issuer). The IIBLP also intends to develop a model text for use in a government regulation, contract, or cover letter to applicants providing for an acceptable standby or confirmation in favor of the government.

This ISP98 Form 11.1, including its extensive endnotes, is intended to help a government beneficiary develop new standby forms or improve and update existing forms and to incorporate those forms into regulations and underlying contracts. This form should promote clarity and efficiency for all concerned and be reasonably acceptable to applicants and issuers, as well as protect the interests of government beneficiaries. The endnotes explain the text of the form and provide alternative and additional standby wording. They also explain why some wording commonly found in standbys has been omitted as unnecessary or undesirable.

This form incorporates ISP98, the only practice rules developed specifically for standby letters of credit. ISP98 was produced by an Institute of International Banking Law and Practice ("IIBLP") working group, endorsed and published by the International Chamber of Commerce ("ICC") as ICC Publication No. 590, and also endorsed by the United Nations Commission on International Trade Law. See http://www.uncitral.org/pdf/english/texts_endorsed/ISP98_e.pdf. This form is based on ISP98 Forms 1 (Model Standby Incorporating Annexed Form of Payment Demand with Statement) and 2 (Model Standby Providing for Extension and Incorporating Annexed Form of Payment Demand with Alternative Non-Extension Statement), the first two of many standby forms that are now freely available on the IIBLP website at http://www.iiblp.org under ISP Forms. This ISP98 Form 11.1 focuses on drafting issues that are of particular interest to government beneficiaries and to issuers and applicants for government standbys.

This form includes terms that ISP98 indicates should be included in a standby, and it restates other ISP98 rules for the avoidance of doubt, e.g., it recites that the standby is irrevocable and independent. It focuses on standbys that are issued from the United States and therefore governed by the applicable state version of the Uniform Commercial Code, Article 5–Letters of Credit ("UCC Article 5" or " UCC § 5-101" et seq)[38] and affected by applicable bank regulations such as the Office of the Comptroller of the Currency ("OCC") regulation 12 C.F.R. § 7.1016 (Independent undertakings to pay against documents).[39] See *LC Rules & Laws: Critical Texts* (IIBLP), which reproduces 12 C.F.R. § 7.1016, as well as UCC Article 5 and the Official Comments to it (with a listing of the dates of each state's enactment and of significant state variations) and ISP98 and certain ISP98 Forms.

This form is intended to be self-contained, and, absent special circumstances, useable without extended reference to the text of ISP98 or to other ISP98 Forms or their endnotes or to UCC Article 5. This form incorporates annexed forms of payment demand which provide maximum clarity as to what the beneficiary must present to the issuer in order to obtain payment under the standby. It assumes that a government beneficiary starting with this form as a model will redraft this form before approving it for general use and that its approved form will allow for some variation as well as insertion of details when a particular standby is issued.

This form is intended to satisfy requirements in U.S. banking regulations as well as letter of credit law and practice as to what constitutes an "independent" undertaking. It also takes into account the OCC's safety and soundness considerations in 12 C.F.R. § 7.1016(b)(3) that an issuing bank "should possess operational expertise that is commensurate with the sophistication of its independent undertaking activities." In light of the differences in standby expertise among bank issuers and the likelihood that regulation of standbys will continue to evolve, this form has been developed to permit government agencies as beneficiaries to allow for standbys to be issued by credit-worthy banks that may lack the experienced operations' capabilities of the major bank letter of credit issuers.

Because many government standbys support underlying obligations that are expected to run for more than one year, this form includes standby text providing for automatic one-year extensions. The duration, as well as amount, of bank exposure under a standby providing for automatic extensions raises bank safety and soundness issues, and therefore the extent of operations' expertise required of any particular bank. Uncertainty as to the duration of a standby is one of several safety and soundness concerns with many existing government standby forms. Another such concern is with non-documentary conditions, which undercut the independence of a standby and introduce uncertainty in the interpretation of its requirements. See endnote 5 (Independence) on standby text recognizing, e.g., a beneficiary's "assigns" without specifying the documents to be presented to evidence the status of a claimed assignee.

Although this form is for use with ISP98 in the United States under UCC Article 5, it could be readily adapted for other uses, e.g., as a model ISP98 government standby or demand guarantee form for use in other countries. See endnote 24 (Incorporation of ISP98; optional choice of law and forum).

This ISP98 Form 11.1 is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98 and *LC Rules & Laws: Critical Texts*, are available from IIBLP at www.iiblp.org.

[*IIBLP as of 5 November 2014*]

Table of Endnotes

1. Name and address of beneficiary
2. Applicant
3. Date and place of issuance
4. Irrevocability
5. Independence
6. Nomination
7. Amount available
8. Annexed form of payment demand
9. Annexed form or payment demand after notice of non-extension
10. Annexes to be completed as indicated
11. Manner of presentation
12. Place of presentation
13. Presentation during business hours
14. Presentation of the original standby not required
15. Overdrawing
16. Expiration
17. Automatic extension
18. One year; 30 days
19. Retraction of non-extension notice
20. Send or receive
21. Final expiration date
22. Three days to examine and pay a presentation
23. Place and method of payment
24. Incorporation of ISP98; optional choice of law and forum
25. Charges and fees for issuance, advice, and confirmation
26. Communications
27. Demand issuance date
28. Information to be inserted in annexed demand form before standby is issued
29. Beneficiary statements
30. "Applicant" as underlying obligor
31. Obligated/default
32. Identification of underlying obligations; use of proceeds
33. Request for wire transfer to beneficiary's account
34. Signer authentication
35. Original signature
36. Annex B endnotes
37. Retraction or replacement standby
38. References to UCC Article 5
39. Banking regulations

[1] Name and address of beneficiary. This ISP98 Form 11.1 assumes that the beneficiary will be a government entity using its legal name. The beneficiary's address should include a street address and the name or title of the person or department to whose attention the standby is directed (attention party). These details will facilitate written communications to be made through a courier as well as mail. A post office box number or other artificial address will not suffice. See endnotes 20 (Send or receive) and 26 (Communications).

Naming more than one beneficiary is unusual (except where the beneficiaries are joint obligees of the applicant) and requires beneficiary, applicant, and issuer attention to the allocation of beneficiary rights to draw, to consent to amendment or cancellation of the standby, and to request acknowledgement of a requested transfer or assignment of proceeds.

If a government beneficiary undergoes a name change, with or without reorganization, then UCC § 5-113 (Transfer by Operation of Law) entitles the legal successor to draw either in its own name or in the name of the predecessor government beneficiary. ISP98 Rules 6.11—6.14 (Transfer by Operation of Law) facilitate both types of drawing.

The ability of an entity other than the named beneficiary or its legal successor to draw depends on ISP98 Rules 6.01 – 6.05 (Transfer of Drawing Rights) and UCC § 5-112 (Transfer of Letter of Credit). Unless expressly permitted in the standby, these provisions prohibit transfers of drawing rights. They do so for the protection of named beneficiaries as well as applicants and issuers. See ISP98 Form 4 (Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand) endnotes 1-3 on the special treatment of transferees at the time of standby issuance and of any attempted transfer by the beneficiary or attempted drawing by a claimed transferee.

If the beneficiary requests the issuer to pay to a third party part or all of any honored presentation, then that request is for an assignment of proceeds rather than a transfer of drawing rights. Assignments of letter of credit proceeds are governed by ISP98 Rules 6.06—6.10 (Acknowledgement of Assignment of Proceeds) and UCC § 5-114 (Assignment of Proceeds). (They are also subject to secured transactions laws.) They are less exceptional than transfers of drawing rights. See ISP98 Form 4 endnote 1 on the differences between transfers and assignments under the special laws and practices applicable to letters of credit.

Assignments of proceeds require some individualized treatment either at the time of issuance or, more typically, at the time of a request for acknowledgement of an attempted assignment of proceeds to a named assignee. An issuer's acknowledgement may be provided in a separate acknowledgement form that protects the issuer against any additional risks associated with paying someone other than the named beneficiary. Many issuers regularly acknowledge assignments of proceeds on standard assignment forms with standard screening of the proposed assignee and for a modest fee. Endnotes 23 (Place and method of payment) and 33 (Request for wire transfer to beneficiary’s account) include optional standby text that would acknowledge an assignment of proceeds made by the beneficiary's presentation of a complying demand that included a request to pay proceeds to an identified account of an identified third party.

A standby that undertakes to pay the named beneficiary's "successors" or "assigns", without more, does not add to the rights of the named beneficiary or its claimed legal successors, transferees, or assignees of proceeds or otherwise circumvent the limitations imposed under ISP98 and UCC Article 5. Only a legal successor covered by UCC § 5-113 (Transfer by

Operation of Law) and ISP98 Rules 6.11—6.14 (Transfer by Operation of Law) would be protected (with or without a reference to successors or assigns in the standby). Any other type of claimed successor, transferee, or assignee would need the issuer's acknowledgement of its claimed status.

Similarly, a standby that engages with "drawers, endorsers, and bona fide holders" would be using an outmoded form of nominating other banks to negotiate complying drafts under a UCP commercial letter of credit (see Official Comment 7 to UCC § 5-102). It would not satisfy ISP98 requirements for nomination or excuse a claimed bona fide holder from having to obtain the issuer's acknowledgement of its status. See endnote 5 (Independence) on the separate need to satisfy ISP98 Rule 4.11 (Non-Documentary Terms or Conditions) as applied to a term like “bona fide holder”.

[2] Applicant. The applicant named in a standby is typically the person whose underlying obligations to the government beneficiary are supported by the standby. See endnote 30 ("Applicant" as underlying obligor). For issues that may arise where the applicant is not the underlying obligor or where there are multiple applicants, see ISP98 Form 1 endnotes 1 and 30.

[3] Date and place of issuance. Standbys commonly recite the issuance date and the place of issuance) at the top of the undertaking or in the first paragraph of the text (or both).

The indicated place of issuance is significant in determining what law governs the issuer’s obligations. Absent an indication of the place of issuance in the standby, it may prove difficult to determine a single place of issuance, even with full knowledge of the process resulting in sending the standby to the beneficiary. See endnote 12 (Place of presentation), which may differ from the place of issuance.

[4] Irrevocability. It is unnecessary to state that an ISP98 standby is irrevocable. See ISP98 Rule 1.06(a) and (b) (Nature of Standbys) and UCC § 5-106(a) (Issuance, Amendment, Cancellation, and Duration). This ISP98 Form 11.1 includes the word “irrevocable” for comfort.

[5] Independence. It is unnecessary to state that an ISP98 standby issued in the U.S. is independent. The obligation of the issuer to honor a complying presentation is independent from the applicant-beneficiary and applicant-issuer relationships as a matter of law, as well as practice rule. See ISP98 Rules 1.06(c) (Nature of Standbys) and 1.07 (Independence of the Issuer-Beneficiary Relationship) and UCC § 5-103(d) (Scope). This central feature of a letter of credit distinguishes it from ordinary guarantees and suretyship promises. This ISP98 Form 11.1 includes the word “independent” for comfort.

ISP98 Rule 4.11 (Non-Documentary Terms or Conditions), like UCC § 5-108(g) (Issuer’s Rights and Obligations), provides that non-documentary conditions in a standby must be disregarded. This rule is intended to protect the independence of an undertaking issued subject to ISP98 (or UCC Article 5). Common examples of non-documentary conditions include standby provisions

that payment or termination of the underlying obligation will reduce or accelerate expiration or otherwise affect the standby issuer's obligations. They tend to mislead applicants who do not appreciate that the issuer must ignore them. Similarly, rights under a standby extended to "bona fide holders of complying drafts" or to "assigns" of the named beneficiary are unenforceable unless the standby clarifies whether nomination, transfer of drawing rights, or assignment of proceeds is intended and then also how such intended rights may be invoked by the presentation of documents that are specified in the standby text or ISP98 Rule 6 (Transfer, Assignment, & Transfer by Operation of Law). Some government standby forms run undue risks under the "non-documentary conditions must be disregarded" rule. This ISP98 Form 11.1 does not.

It is undesirable to state that a standby is “unconditional”, “primary”, or “absolute”. See ISP98 Rule 1.10(a) (Redundant or Otherwise Undesirable Terms). A standby is by legal and practice rule definition a conditional undertaking, conditioned on the timely presentation of complying documents. As such, its undertaking to pay is not "unconditional" or "absolute" when issued (although it may become such after a complying presentation is made). The term “primary” has no meaning in letter of credit law or practice and confuses letters of credit with suretyship undertakings.

It is unnecessary to include any so-called integration or merger clause (e.g., “This letter of credit sets forth in full issuer’s undertaking, and such undertaking shall not in any way be modified, amplified or amended by reference to any document, instrument, agreement or note referred to herein and any such reference shall not be deemed to be incorporated herein by reference to any such document, instrument, agreement or note.”). No such recital can usefully supplement any standby subject to ISP98 (or governed by UCC Article 5). Such clauses should be avoided because they might detract from the more authoritative and better worded statements of standby independence in ISP98 Rules 1.06(c) (Nature of Standbys) and 1.07 (Independence of the Issuer-Beneficiary Relationship) and UCC § 5-103(d) (Scope). Such clauses should also be avoided because they invite application of contract law principles relevant to a bargain between the issuer and beneficiary, rather than letter of credit law principles relevant to an independent undertaking of the issuer. See ISP98 Form 5 (Simplified Demand Only Standby) endnote 1.

Similarly, it is unnecessary for a standby to recite that payment under it will be made from the issuer's own funds. The independence of the issuer's obligation as a matter of law assures that the issuer's payment discharges the issuer's obligation without regard to the effect of that payment on the applicant's underlying obligations. An "own funds" recital does not and cannot protect a beneficiary against claims from an applicant (or a bankrupt applicant's representative) based on the underlying applicant-beneficiary relationship.

[6] Nomination. This ISP98 Form 11.1 does not include a request that it be advised to the government beneficiary through another bank. Advice signifies that the advisor has checked the apparent authenticity of the standby and accurately advised what it has received. See ISP98 Rule 2.05 (Advice of Standby or Amendment) and UCC § 5-107(c) (Confirmer, Nominated Person, and Adviser). Use of an advising bank is a simple and inexpensive way to reduce the

beneficiary's risk of relying on a forged standby. (The terms "advisor", "adviser", and "advising bank" are used interchangeably to refer to these limited functions, and use of the term “bank” recognizes that nomination is almost invariably of a bank and not of any limitation on non-banks acting under ISP98.)

This form could provide for advice by addressing the standby to the advisor and adding a new second paragraph, e.g.: “Advisor: **[name and address(es) of beneficiary's bank]** is requested to advise Beneficiary of the issuance of this Standby. Issuer undertakes to route any amendment, notice of non-extension, or other communication affecting this Standby through Advisor to advise Beneficiary thereof [and to receive communications from Advisor as authentic communications from the indicated officer or other representative of Beneficiary].”

A government beneficiary may wish to consider requiring that one or more banks chosen by it be nominated in substantially all standbys issued in its favor to advise them. This step would provide a valuable check of the authenticity of the standby and might facilitate record keeping for the government on issuances, amendments, notices of non-extension, etc., as well as timely presentation of the government beneficiary's demands. See endnote 6 (Nomination).

The suggested text above could be expanded to provide for presentation to the issuer by authenticated SWIFT inter-bank message quoting the beneficiary's demand rather than by courier delivery of the beneficiary's originally signed demand.

Nomination of another bank in a standby could be expanded to provide for confirmation (see the General Comments) or to authorize giving value against a complying presentation, which is beyond the scope of this ISP98 Form 11.1. As stated in ISP98 Rule 2.04 (Nomination), nominated banks are not bound by the issuer’s nomination or authorized to bind the issuer, nor are they governed by the same laws. See endnotes 24 (Incorporation of ISP98; optional choice of law and forum) and 25 (Charges and fees for issuance, advice, and confirmation).

[7] Amount available. ISP98 Rule 3.08 (Partial Drawings & Multiple Presentations; Amount of Drawings) permits presentations for less than the amount available under a standby. See ISP98 Form 3 (Model Standby Providing for Reduction and Incorporating Annexed Form of Reduction Demand) on the possibility of reducing the amount available other than by honoring a payment demand.

It is unnecessary to state in a standby, or in a demand form, that the amount demanded must be, or is, available under the standby. The amount available is determinable without dependence on any such statement. See endnote 15 (Overdrawing).

[8] Annexed form of payment demand. ISP98 Rule 4.08 (Demand Document Implied) requires presentation of a documentary demand for payment. Each requirement for the presentation of a document should appear in the standby text specifying the document(s) to be presented and not merely as a recital in an annexed form of demand or required beneficiary statement.

This ISP98 Form 11.1 does not require presentation of a "draft" but instead requires a demand. Requiring a draft, whether or not as the only document to be presented, is neither necessary nor efficient under a standby that undertakes to pay at sight. (ISP98 Rule 4.16(c) (Demand for Payment) provides that a "draft" need not be in negotiable form.)

This ISP98 Form 11.1 incorporates an annexed model form of payment demand to be completed and presented by the beneficiary. Annexing the desired form of payment demand (with any desired beneficiary statement) is not required by ISP98 but promotes the efficient use of standbys. Annex A satisfies the requirements of ISP98 Rule 4.16 (Demand for Payment), so that, when the government beneficiary completes the annexed form as indicated, it will include a demand for payment of a stated amount under an identified standby, be properly addressed, dated, and signed, and contain any required beneficiary statement.

While not optimal, Annex A could be deleted as a self-contained demand form and merged into the body of the standby with additional wording that would require that the demand be presented to the issuer’s indicated address, mention the standby reference number, be dated and signed by the beneficiary, and include the beneficiary statements that are now included in Annex A. A statement included in blocked wording or quotation marks in the body of a standby, like a statement included in an attached form such as Annex A, would be covered by ISP98 Rule 4.09(b) (Identical Wording & Quotation Marks). See endnote 29 (Beneficiary statements) on the ISP98 standards for determining whether a beneficiary statement complies with the requirements of the standby.

Annex A includes a beneficiary statement that the applicant is obligated to pay the amount demanded as provided in an identified underlying contract, without further indicating the source or nature of the underlying payment obligations.

The underlying contract should be identified in Annex A when the standby is issued. While some standbys call for a draft only or for a payment demand that does not identify the underlying obligations intended to be supported by the standby, increasing concern regarding anti-money laundering has caused banks to press for the inclusion of such information. In this regard, government beneficiaries should set an example in their forms. Separately, there is the chance of dispute as to which particular underlying obligations are or are not to be satisfied or secured by any particular drawing under a particular standby. UCC §§ 5-110 (Warranties) and 5-117 (Subrogation of Issuer, Applicant, and Nominated Person) provide post-honor warranty and subrogation rights and remedies, which, together with the law applicable to the government beneficiary's relationship with the applicant, allow for an extended inquiry into the intentions of the parties regarding whether a payment received under a standby should be returned or differently applied.

Assuming that the applicable regulation or contract requires that the applicant provide and maintain acceptable standby support, it should also require that the imminent failure to maintain

acceptable standby support will require timely payment either to satisfy or secure the underlying payment obligations supported by the standby. The beneficiary may then make the statement required in the Annex A form of payment demand, whether the problem is that the standby is set to expire too soon or the issuer or confirmer ceases to be acceptable to the government beneficiary.

The standards by which bank acceptability (notably creditworthiness) are to be measured are best addressed in the government's underlying contract or regulation. Attempting to address bank acceptability in the text of the standby or confirmation is problematic and is resisted by many banks.

[9] Annexed form of payment demand after notice of non-extension. Optional Annex B should be included if the standby provides for automatic extension and if the applicable government regulation or contract does not provide any basis for using Annex A to demand payment because the issuer has given a notice of non-extension. It is simpler and more efficient to provide in the applicable regulation or contract that any failure to maintain a sufficient standby entitles the government to payment before the standby terminates either by acceleration of the underlying obligations or by triggering an underlying obligation to cash collateralize any underlying payment obligations that are still contingent or unmatured. Following this approach in the underlying documentation would make it unnecessary to include an Annex B (or to add to Annex A an alternative beneficiary statement in lieu of a separate Annex B).

[10] Annexes to be completed as indicated. The phrase “completed as indicated” assumes that the annexed form of demand adequately indicates how the beneficiary is to complete it before presenting it. This form includes instructions to complete text in **[bold]** before issuance and instructions for the beneficiary to complete text in [ALL CAPITALS UNDERLINED] before presentation.

Consistent with ISP98 Rule 4.16 (Demand for Payment), the annexed forms of demand require dating and signing. Neither the standby text nor any annexed demand form purports to permit “purported” signatures, an adjective which obscures the allocation of risks for forged demands under UCC § 5-108(i)(5) (Issuer’s Rights and Obligations) to the possible disadvantage of the true beneficiary. See ISP98 Form 1 endnote 10.

[11] Manner of presentation. This ISP98 Form 11.1 provides for presentation by delivery of documents in a paper form, commonly by courier, as does ISP98 Rule 3.06 (Complying Medium of Presentation) with the exception of a standby to a beneficiary that is a SWIFT participant and that requires only a demand, an exception not typically applicable to a government beneficiary.

Presentation by telefax is commonly expressly permitted in standbys as an alternative to physical presentation of original paper documents. With telefax presentation a scan of a paper document is transmitted to a specified telephone number that is accessible and, preferably, controlled by standby operations' personnel. Whether and how standby issuers may permit telefax presentation

varies considerably. Express provision in the standby for such presentations is required, but there is no standard text. The following may be considered as a starting point for the development of standby text permitting presentation by telefax: “Presentation of any demand under this Standby may also be made by telefax sent from **[Beneficiary's telephone number(s)]** to **[Issuer's telephone number(s)]** with a cover sheet marked 'URGENT. FAX PRESENTATION UNDER STANDBY LETTER OF CREDIT **[REFERENCE NO.]**', and the document(s) received and printed out by Issuer shall be deemed to be original under ISP98 Rule 4.15 (Original, Copy, and Multiple Documents). Beneficiary is requested to telephone Issuer at **[telephone number(s)]** and to identify this Standby and Beneficiary's presentation being telefaxed that same business day, as a courtesy and not as a condition limiting Issuer’s obligations.” Some standbys add wording on the disposition of any original paper documents, e.g., requesting that they also be presented to the issuer as a courtesy or disclaiming responsibility for examining them whether received before or after an honored fax presentation.

Electronic presentation, e.g., by message with pdf attachment to an issuer's e-mail address, is not common. Many issuers do not permit this manner of presentation. Those that do, do so in limited circumstances and on their own individualized terms. ISP98 rules would facilitate the drafting of an issuer's individualized clause permitting electronic presentation. See ISP98 Rule 1.09(c) (Defined Terms (“Electronic Record”, “Authenticate”, “Electronic Signature”, and “Receipt”)).

[12] Place of presentation. ISP98 Rule 3.01 (Complying Presentation under a Standby) provides that a standby should indicate the place, the location within that place, and the person to whom presentation should be made. ISP98 Rule 3.04 (Where and to Whom Complying Presentation Made) provides default rules. The indicated place of presentation is significant in determining whether a complying demand is timely presented.

This ISP98 Form 11.1 provides for presentation to the issuer at a specified place, which might be an operations' office of the issuer with a name or address that differs from the name or address given for the issuer at the place of issuance or as the location of the particular branch of the bank that issued the standby. Many issuers limit presentation to one place or only a few places where they maintain standby operations, and in some cases those operations' centers are bank affiliates that specialize in letter of credit operations.

Bank security measures typically do not permit attempted presentation by in-person delivery to a bank's standby operations' personnel. Standbys typically require that any presentation be addressed to a street address and to the attention of the Standby Letter of Credit Department or the like. These requirements are intended to accommodate presentation of paper documents by mail or courier and to facilitate internal routing of incoming mailed or couriered packages from a mail room at the stated street address to standby operations' personnel. Providing for presentation "at the counters" of the issuer is as outmoded as it is imprecise.

This ISP98 Form 11.1 does not provide for the possibility of presenting at an alternative address of the issuer or of any nominated bank.

[13] Presentation during business hours. ISP98 Rule 3.05 (When Timely Presentation Made) provides that presentation must be made before expiry on the expiration date and that a presentation after business hours is treated as made the next business day. Although Rule 9.04 (Time of Day of Expiration) provides that expiry occurs at the close of business at the place of presentation, this phrase is included in this ISP98 Form 11.1 for the avoidance of doubt.

[14] Presentation of the original standby not required. An issuer's obligation is not dependent on the beneficiary's holding or presenting the "original" standby, unless the standby so provides. See ISP98 Rule 2.03 (Conditions to Issuance). This ISP98 Form 11.1, like most standbys, does not require presentation of the standby with a payment demand. Any such requirement exposes the government beneficiary to the unnecessary risk that a demand may be rightfully refused if the standby is lost or otherwise cannot be timely presented. It also exposes the issuer to disputes over the issuer's receipt, handling, or return of the standby. The typical justification for such a requirement is to deter forged demands, but there are other better ways to deter forged demands, e.g., by providing in the standby that payment must be made to a specified bank for credit to a specified government beneficiary's account. See ISP98 Form 1 endnote 9.

If despite this recommendation the standby text is redrafted to require presentation of the standby (e.g., by adding: "and accompanied by the original standby"), then any annexed demand form should add corresponding text. In that event, consideration should also be given to adding a provision in the standby text requiring the reasonable exercise of issuer discretion under ISP98 Rule 3.12 (Original Standby Lost, Stolen, Mutilated, or Destroyed), e.g.: "Issuer undertakes to exercise its discretion under ISP98 Rule 3.12 to waive the requirement to present this Standby (or to replace it) against assurances and indemnities that are satisfactory to Issuer and made in favor of Issuer and Applicant." Under this clause the issuer would determine what is satisfactory, but the applicant would bear the ultimate risk of payment against a forged demand.

[15] Overdrawing. This sentence supersedes ISP98 Rule 3.08(e) (Partial Drawing and Multiple Presentations; Amount of Drawings) which provides that a drawing that exceeds the amount available under the standby is discrepant. This superseding sentence requires the issuer to pay the full amount available under the standby against a presentation that would comply but for the overdrawing. Inclusion of this sentence should be reconsidered if the standby requires presentation of a valuable document that the beneficiary might prefer be returned rather than delivered for less than the amount demanded.

This sentence could be enhanced by adding the phrase "notwithstanding ISP98 Rule 3.08(e)", but such an addition is unnecessary and might put into question other standby provisions that supersede other ISP98 rules. This ISP98 Form 11.1 does not recite the exclusion or modification of an ISP98 rule where the wording in the standby is "specific and unambiguous". See ISP98 Rule 1.11(d)(iii) (Interpretation of these Rules). The undertaking "to pay the amount available" is sufficiently specific and unambiguous to supersede ISP98 Rule 3.08(e) as to the effect of an overdrawing.

[16] Expiration. This ISP98 Form 11.1 is based on the common practice of stating a specific calendar date for expiry. See ISP98 Rule 9.01 (Duration of Standby), UCC § 5-106 (Issuance, Amendment, Cancellation, and Duration), and OCC regulation 12 C.F.R. § 7.1016(b)(1)(iii).

The stated expiration date should be set sufficiently after the underlying obligation becomes due to allow for obtaining internal authorization to make a drawing, to satisfy any timing or other requirement for drawing provided in the relevant government regulation or contract, and to make a curative drawing after any refusal of an initial drawing. If payment of the underlying obligation may be made outside of the standby, the stated expiration date should be set to allow for drawing after any possible rescission of an outside payment made by an insolvent payer.

The expiration date stated in a standby is not necessarily the last day on which a complying presentation may be made under the standby. ISP98 Rule 3.13 (Expiration Date on a Non-Business Day) automatically extends a weekend expiration date to the next business day. ISP98 Rule 3.14 (Closure on a Business Day and Authorization of Another Reasonable Place for Presentation) extends by at least 30 days an expiration date that occurs on a business day when the issuer is closed for any reason (including force majeure).

ISP98 Rule 3.14 may be restated in standby text, e.g.: "If on the last business day for presentation the place for presentation stated in this Standby is for any reason closed and Beneficiary does not make timely presentation because of the closure, then the last day for presentation is automatically extended to the day occurring 30 calendar days after that place for presentation re-opens for business or, if earlier, 30 calendar days after Issuer gives Beneficiary a written notice in which Issuer authorizes another reasonable place for presentation and that place is open for business on the last day for presentation and on each of the preceding 15 business days."

ISP98 Rule 3.14(a) does not apply where the issuer is open on the expiration date but closed in the days preceding the expiration date. The above provision could be expanded, e.g.: “If on the last business day for presentation or on any of the preceding 15 business days . . . .”

[17] Automatic extension. This paragraph on automatic extension should be included only in standbys that are outstanding long enough to require automatic extension of the stated expiration date.

Automatic extension provisions in standbys have arisen out of regulatory, commercial law, and practical business concerns about indefinite or overlong exposure under bank letters of credit. In addition to safety and soundness considerations, UCC § 5-106 (Issuance, Amendment, Cancellation, and Duration) limits the duration of letters of credit that are indefinite to one year and those that purport to be perpetual to five years. Moreover, prudent banking practices would suggest an annual re-evaluation of the applicant’s credit standing. These considerations have resulted in standby provisions that set the expiration date at one year after issuance and then

provide for automatic one-year extensions, subject to the issuer's giving a notice of non-extension allowing for a drawing before the standby expires.

ISP98 Rule 2.06(a) (When an Amendment is Authorised and Binding) makes "automatic amendments" effective without further notification or consent if the automatic amendment is expressly stated in the standby. Accordingly, it is desirable to include the word "automatic" in any standby clause intended to make an amendment effective based on the terms of the standby and not by obtaining the beneficiary's consent. It is unnecessary to recite that an automatic extension is "without amendment" or that an automatic extension clause is a "condition".

This ISP98 Form 11.1 uses the words "extend" and "non-extension", and not "renew" or "non-renewal" or "reinstate", to make clear that the intent is to amend, and not replace, the standby and not to affect the amount available.

The word "evergreen" is popularly used to refer to automatic extension clauses; however, this word cannot substitute for, or usefully supplement, an automatic extension clause. See ISP98 Rule 1.10(c)(ii) (Redundant or Otherwise Undesirable Terms).

An automatic extension clause does not render a standby perpetual. Official Comment 4 to UCC § 5-106 (Issuance, Amendment, Cancellation, and Duration) makes clear that an automatically extending letter of credit is not perpetual if it may be terminated in the issuer's discretion by notice to the beneficiary. See also 12 C.F.R. § 7.1016(b)(1)(iii)(B) (terms should permit national bank to terminate the undertaking either on a periodic basis or at will upon either notice or payment to the beneficiary).

[18] One year; 30 days. The period of one year is the standard time frame for successive automatic extensions to facilitate annual credit reviews by U.S. bank issuers of their applicants. This sentence sets as the expiration date the same calendar month and date for each succeeding one-year period in accordance with standby practice and ISP98 Rule 9(b) (Timing).

A 30-day period for giving or receiving a notice of non-extension is common, but a longer period (e.g., 60 days) may be appropriate. The length of that period is affected by the length of time expected for (i) the issuer to re-approve the applicant's credit, (ii) the applicant to replace the standby, and (iii) the government beneficiary to draw as permitted by the standby and the underlying transaction. The government's regulation or contract should address requirements for satisfactory replacement. See endnote 37 (Retraction or replacement standby).

[19] Retraction of non-extension notice. Standby operations' personnel may not receive credit approval for extension before the date required to initiate sending a timely non-extension notice and, as a result, may issue an effective notice of non-extension and later receive credit approval for extension. While the Annex B demand form includes an optional reference to retraction, this ISP98 Form 11.1 does not authorize the issuer to give a notice of retraction. To authorize an effective retraction, the following clause should be considered for insertion in the standby text: "At any time before the next expiration date Issuer may retract its notice of non-extension by

giving Beneficiary a written notice of retraction in the same manner as giving notice of non-extension and thereby automatically extend the expiration date." Retraction and replacement are best addressed in the underlying regulation or contract, because it is difficult for standby text to cover all of the variations that may arise, including treatment of any demands made after a notice of non-extension is given.

[20] Send or receive. Automatic extension clauses differ in the extent to which they spell out where and how a notice of non-extension must or may be sent to, or be received by, the beneficiary in order to establish an expiration date that is not subject to further automatic extension. Given the "independent" and formal relationship of an issuer to a beneficiary, there are considerable practical difficulties in determining or proving whether and when a notice has been given by an issuer to a beneficiary. They are multiplied for all concerned if a notice must also be given to the applicant or other party, as well as the beneficiary. See ISP98 Form 2 (Model Standby Providing for Extension) endnote 4.

Some courts apply strict compliance concepts to issuer notices to a beneficiary. Any clause on giving a non-extension notice should provide for a workable limitation on a standby's duration by the giving of advance notice and should be supplemented by a final expiry date so as to avoid uncertainty as to the duration of the standby and avoid any need for indefinite retention of proof of due expiry. This ISP98 Form 11.1 requires that a non-extension notice be in writing and given to the beneficiary by means which allow for tracking delivery by mail or courier service to the beneficiary 's address as stated in the standby. This form also provides for an alternative of giving an effective notice by proving actual timely receipt by the beneficiary in the absence of proof of delivery by mail or courier.

[21] Final expiration date. If a standby provides for automatic extensions, then an end date for automatic extensions, even if it is set many years in the future, is highly desirable. Such a final date is important for bank safety and soundness reasons, as well as issuer's and confirmer’s record-keeping purposes, particularly to avoid having to retain indefinitely proof that a standby was terminated by expiration following an effective notification of non-extension (or was honored or otherwise reduced to zero).

This ISP98 Form 11.1 suggests a final expiration date set five years after standby issuance based on the five-year limitation on "perpetual" letters of credit in UCC § 5-106(d) (Issuance, Amendment, Cancellation, and Duration) discussed in endnote 17 (Automatic extension).

Assuming that the underlying government regulation or contract provides that a required standby must remain outstanding as long as the underlying obligations are outstanding and that imminent expiry will entitle the beneficiary to claim payment before expiry (see endnote 8 (Annexed form of payment demand)), the government beneficiary would have sufficient leverage to obtain either a timely extension of the final expiration date or payment before expiry. The final expiration date of the standby can always be extended by amendment in the usual way, i.e., by the issuer's issuance of an amendment that satisfies the signed writing requirement of UCC § 5-104 (Formal

Requirements) to which the beneficiary consents as required by ISP98 Rule 2.07 and UCC § 5-106(d).

[22] Three days to examine and pay a presentation. ISP98 Rules 2.01(c) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) and 5.01 (Timely Notice of Dishonour) provide for the time an issuer has to honor or dishonor and include a safe-harbor of three business days after presentation. That three-day period begins on the business day following the business day of presentation. This standby text converts that three-day safe harbor period in ISP98 into a timing requirement for payment of a complying presentation. This standby text would supersede the ISP98 rule, and both would supersede the "reasonable time" provision in UCC § 5-108(b) (Issuer's Rights and Obligations).

[23] Place and method of payment. If a standby does not state an exclusive place or method of payment, then an issuer may voluntarily follow the presenter's request. See ISP98 Rule 5.08 (Cover Instructions/Transmittal Letter). Annexes A and B in this ISP98 Form 11.1 include a provision to be completed by the beneficiary to request payment by wire transfer. This provision requires that the beneficiary's demand for payment identify the beneficiary's bank and the beneficiary's account to be credited by that bank. (Under UCC § 4A-406 acceptance by the beneficiary's bank of a funds transfer for credit to the beneficiary's account satisfies the issuer's payment obligation.) See endnote 33 (Request for wire transfer to beneficiary's account), which notes that a request to pay an entity other than the beneficiary is an attempt to assign proceeds.

Including the method of payment in the text of a standby when issued may deter forged beneficiary demands, as well as avoid delays resulting from the issuer's receipt of an inadequate request as to the method of payment. If payment by wire transfer is desired, the following standby text may be substituted (and completed before the standby is issued): "Payment shall be made by wire transfer to an account of Beneficiary as follows: **[name, address, and routing number of Beneficiary's bank, and name and number of Beneficiary's account]** or to such other bank account of Beneficiary as Beneficiary may duly request of Issuer". If payment by check is desired, the following standby text may be substituted: "Payment shall be made by Issuer's check payable to Beneficiary sent to Beneficiary's above-stated address by nationally recognized overnight courier."

If an assignment of proceeds is contemplated, one way to provide for it and to limit the issuer's discretion to decline to acknowledge it would be to add to the standby text here: "or of Beneficiary's assignee of proceeds identified in Beneficiary's demand with the assignee's name and address, the name and routing number of the assignee's bank in the United States, and the name and number of the assignee's account to be credited. Issuer shall acknowledge any such request for an assignment of proceeds, subject only to compliance with mandatory applicable law." This additional standby text, with a corresponding addition in Annex A (and in any other form of assignable payment demand) would constitute the issuer's advance acknowledgement of a possible future assignment of proceeds to an assignee adequately identified in a beneficiary's complying demand directing payment to the beneficiary's named assignee. Accordingly, the

issuer (as well as the government beneficiary) might want to include a beneficiary statement that, e.g., the assignee will be using the standby proceeds for a purpose required or permitted by the underlying contract or regulation or will be holding proceeds as a trustee, custodian, or the like representing one or more third parties with government recognized claims against the applicant. See ISP98 Rule 6.08 (Conditions to Acknowledgement of Assignment of Proceeds), listing conditions that an issuer might consider before agreeing in advance to acknowledge an assignment of standby proceeds.

An issuer's response to a beneficiary's request may be affected by regulatory requirements limiting wire transfers to a permissible financial institution for credit to a permissible account in a permissible country. No matter what a standby, demand form, or separate request for routing payment may state, applicable law, e.g., a court or government order, may block payment.

Issuers rarely undertake to send an advice of payment to beneficiaries. In the unusual case where beneficiaries lack access to reports that their requested wire transfers were received and credited by their banks, the following clause might be added: "A notice of such payment shall be sent to Beneficiary's above-stated address."

[24] Incorporation of ISP98; optional choice of law and forum. UCC § 5-116(c) (Choice of Law and Forum) provides that incorporated "rules of custom or practice" will govern an issuer's liability and will supersede conflicting UCC Article 5 provisions, except for the few that are non-variable under UCC § 5-103(c) (Scope). Neither ISP98, which postdates UCC Article 5, nor the standby text provided in this ISP98 Form 11.1, including endnotes, conflicts with any of the non-variable UCC provisions.

UCC § 5-116 expressly refers to the Uniform Customs and Practice for Documentary Credits ("UCP") as an example of incorporated practice rules. Before 1998 many domestic standbys were issued subject to a version of the UCP. Many government standbys are still issued subject to UCP500 or UCP600 because government agencies have been slow to update their forms, i.e., to recognize the superiority of UCP600 over UCP500 and of ISP98 over both UCP500 and UCP600 as applied to standbys. This ISP98 Form 11.1 could be adapted for standbys to be issued subject to UCP, with particular attention paid to the UCP's articles on force majeure closure and installment drawings and on the treatment of conflicting data in a presentation. This form could also be adapted for standbys to be issued without incorporating any published practice rules, with the effect of obligating a U.S. bank issuer to observe standard standby practice as well as the specific gap-filling provisions of UCC § 5-108 (Issuer's Rights and Obligations) on compliance, preclusion, and non-documentary conditions. These endnotes do not further address adapting this form for U.S. government standbys issued subject to other practice rules or no practice rules.

This ISP98 Form 11.1 does not include a choice of law or forum clause, relying on UCC § 5-116(b) to apply UCC Article 5 as enacted in the state where the issuer is located. Many standbys issued by U.S. banks to U.S. beneficiaries are silent on applicable law and forum.

Those standbys issued by U.S. banks that do choose law typically restate UCC § 5-116, e.g.: "This standby is issued subject to ISP98 and, as to matters not covered by ISP98, is governed by the law of **[name of the state where the issuer is located]**." A common addition is: "and applicable federal law". There is no need to exclude any state's conflict-of-laws rules; UCC § 5-116(a) as enacted in every state makes the choice of law in a letter of credit absolutely enforceable.

If the standby also includes a forum clause, it typically refers to the same state as that chosen as applicable law, e.g.: "The courts located in **[state]** shall have exclusive jurisdiction over any action to enforce Issuer's obligations under this Standby." UCC § 5-116(e) as enacted in every state makes the choice of forum in a letter of credit absolutely enforceable.

A government beneficiary should consider not only its preferences but also the preferences of otherwise acceptable banks that may resist a choice-of-law or forum clause that chooses a state that has enacted a materially varied version of UCC Article 5 or that has problematic letter of credit case law. Some banks will refuse to issue standbys under such legal regimes, prejudicing applicants' abilities to obtain cost-effective standbys from the bank or banks with which they maintain credit lines and government beneficiaries' abilities to obtain standbys from banks with operational expertise. Some banks will issue standbys subject to the law of one of only a few approved states.

Although state variations in the adoption of UCC Article 5 are relatively few and generally concern remedy issues, whenever UCC Article 5 in a particular state is at issue, consideration should be given to the possibility that there may be a relevant state variation in UCC Article 5. See endnote 38 (References to UCC Article 5). Material state variations of UCC Article 5 are noted in *LC Rules & Laws*.

A standby constitutes the obligations of its issuer. Accordingly, a choice-of-law or forum clause would not necessarily apply to the obligations of a nominated bank and particularly a confirmer, which, in the case of a U.S. bank confirmer would be treated as the issuer of a parallel independent undertaking from a state that may be different from the standby issuer's state.

[25] Charges and fees for issuance, advice, and confirmation. The obligations of an issuer (and confirmer) to honor a complying demand do not allow for deduction or delay unless the standby otherwise states or applicable law otherwise mandates. ISP98 Rule 8 (Reimbursement Obligations) obligates applicants to reimburse issuers and obligates issuers to reimburse nominated banks for their fees and charges; it imposes no such obligations on beneficiaries. Accordingly, this paragraph is included for comfort.

This ISP98 Form 11.1 does not authorize another person to advise, receive presentation, give value, or confirm. The optional sentence referring to the fees and charges of any such "nominated person" should be included only if the standby nominates another to act. See endnote

6 (Nomination) and ISP98 Rule 2.04 (Nomination).

If a beneficiary uses an advising bank to undertake other functions, such as to monitor the standby for imminent expiry or to forward a presentation of documents, those other functions would not be covered by an issuer's undertaking to pay fees for advising the standby.

[26] Communications. This optional clause is included because many bank issuers include in their standbys a standard provision on communications to them (and frequently with a reminder to use the issuer's standby reference number when communicating about the standby). A government beneficiary may wish to develop its own standard provision for communications from issuers to it.

This ISP98 Form 11.1 does not provide for automatic amendment upon notified change of addresses (telephone and electronic as well as physical office addresses, including attention party information). Changing the beneficiary's address may be facilitated by adding "or such other address as Beneficiary may specify in a written notice given to Issuer in the manner required to present a payment demand" or, more formally, by adding the following text and annex: “unless Beneficiary makes a demand in the form of Annex C (Demand for Change of Beneficiary's Address), completed as indicated and presented to Issuer, whereupon Beneficiary's address shall be automatically amended in accordance with Beneficiary's demand."

Annex C: Demand for Change of Beneficiary's Address

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in standby]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer’s name]** (“Standby”).

The undersigned Beneficiary demands that its address for sending all communications related to the Standby be changed from [INSERT PRIOR ADDRESS] to [INSERT NEW ADDRESS], effective on the later of Issuer's receipt or [INSERT DATE].

[Beneficiary’s name]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE]

No similar provision is needed for changes in the address of the issuer because ISP98 Rule 3.14(b) (Closure on a Business Day and Authorization of Another Reasonable Place for Presentation) provides a mechanism for the issuer automatically to indicate a change of the address to which presentation must be made, provided notice thereof is timely received by the beneficiary.

[27] Demand issuance date. ISP98 Rule 4.16(b)(ii) (Demand for Payment) provides that a demand must contain an issuance date, and ISP98 Rule 4.06 (Date of Documents) provides that its issuance date may not be later than the date of its presentation.

[28] Information to be inserted in annexed demand form before standby is issued. The information in bold type at the top of Annex A (addressee and standby identification) should appear in the demand form when the standby is issued and be consistent with the information in the text of the standby. See ISP98 Rules 3.01 (Complying Presentation under a Standby) and 3.03 (Identification of Standby), 3.04 (Where and to Whom Complying Presentation Made), and 3.06 (Complying Medium of Presentation). If these data fields are blank or if there is no annexed demand form, then the beneficiary should provide this information in any demand.

[29] Beneficiary statements. Standbys commonly require presentation of beneficiary statements and commonly combine them with the required form of demand for payment. Words other than “states”, such as “certifies”, “represents”, “warrants”, “promises”, or a combination of those words, can also be used in the applicable government regulation or contract, in which case the required standby form should also use those words.

A standby that requires a statement from the beneficiary and specifies the precise wording is subject to ISP98 Rule 4.09(b) (Identical Wording and Quotation Marks). That rule applies ISP98 Rule 4.01 (Examination for Compliance) so as to excuse the beneficiary from having to reproduce apparent typographical errors and the like in the standby and to excuse apparent typographical errors and the like that may be included in the documents presented. Excusable errors are those apparent when the standby and the documents presented are "read in context", the context being an examination for compliance under ISP98 and not an examination of the underlying transaction.

If the standby does not specify the precise wording, then ISP98 Rule 4.09(a) should be consulted. It allows a presented demand to use any words that "appear to convey the same meaning". Flexibility may also be introduced by adding alternative wording to the annexed form of demand or otherwise generally indicating in the annexed form of demand how blank spaces may be completed.

If no flexibility whatsoever is desired (e.g., because the demand or statement must be delivered to a third person in a precisely specified form), then ISP98 Rule 4.09(c) should be consulted, with the understanding that it should be invoked rarely, that it requires use of the word "exact" or

"identical" in the standby, and that its use may lead to unintended consequences for the issuer, applicant, or beneficiary.

[30] "Applicant" as underlying obligor. This demand form uses "Applicant", which is a defined term in the text of the standby, and assumes that the applicant and beneficiary are parties to the underlying agreement that establishes the obligations to be supported by the standby. If this defined word is omitted from this demand form (as it should be if the "Applicant" is not the counter party to the government beneficiary), the name of the party to the underlying transaction should be inserted here. See endnote 2 (Applicant).

The following text covering defined terms may be appropriately added: "This demand is made in accordance with the terms and conditions, including defined terms, of the Standby and ISP98."

[31] Obligated/default. This beneficiary statement indicates that the applicant is "obligated to pay" the amount demanded, not that there is a "default". A default statement is inapt where the amount demanded is payable on the date demanded without regard to the occurrence or continuance of a default or where "default" is not adequately defined in the underlying contract or regulation or where "default" may require that an action be taken that may be prohibited under laws triggered by the insolvency of the applicant or other party. This model demand form avoids use of and reliance on the word "default".

[32] Identification of underlying obligations; use of proceeds. This demand form includes a reference, which could be general or specific, to the underlying obligations of the applicant to the government beneficiary as provided in the underlying contract or regulation. This approach is desirable for the reasons indicated in endnote 8 (Annexed form of payment demand). As is the case throughout this ISP98 Form 11.1, the government beneficiary is expected to draft model text for its model form with standard references to itself and its regulation, etc., and later to develop with the particular applicant the details for the particular contract to be supported by the standby.

This demand form does not include a beneficiary statement regarding use of any payment received from a drawing under the standby. See ISP98 Form 1 endnotes 31-33 on the optional "use of proceeds" text in Annex A of Form 1. Annex A (and B) of this ISP98 Form 11.1 could usefully add, after an adequate identification of the underlying obligations: "Beneficiary further states that the proceeds from this demand will be used to satisfy or secure the above-identified obligations and that Beneficiary will account to Applicant for any proceeds that are not so used."

[33] Request for wire transfer to beneficiary's account. This term in the demand form implements the payment term in the standby. It may be unnecessary if the text of the standby includes satisfactory wire transfer information for payment to the beneficiary. See endnote 23 (Place and method of payment).

If the standby text provides for a possible assignment of proceeds to be made in the beneficiary's

demand (see endnotes 1 (Name and address of Applicant) and 23 (Place and method of payment)), then the annexed demand form could add, e.g.: "Alternatively, if this demand does not provide account information for Beneficiary, Beneficiary requests that payment be made to Beneficiary's assignee of proceeds, as follows: [INSERT NAME AND ADDRESS OF BENEFICIARY'S ASSIGNEE] by wire transfer to an account of Beneficiary's assignee of proceeds, as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF ASSIGNEE'S BANK, AND NAME AND NUMBER OF ASSIGNEE'S ACCOUNT TO BE CREDITED BY ITS BANK].]" As noted in endnote 23, this added text could also include a beneficiary statement that, e.g., the assignee will be using the standby proceeds for a purpose required or permitted by the underlying contract or regulation or will be holding proceeds as a trustee, custodian, or the like representing one or more third parties with government recognized claims against the applicant. As also noted in endnote 23, an issuer's acknowledging or effecting an assignment of proceeds is subject to laws regulating money laundering, sanctions, and other matters that apply to issuers requested or required to effect payment to an assignee.

[34] Signer authentication. This demand form requires the signer to indicate in the signature line that the demand and statement are made by the named beneficiary located at the address stated in the standby. Accordingly, the beneficiary's name and address should be stated in this demand form when the standby incorporating it is issued. If desired, the title(s) or names(s) of the beneficiary's permitted signers may also be specified in the demand form when the standby is issued.

[35] Original signature. Assuming that Annex A is to be presented as a paper document, when presented it should bear an original signature of an individual with the signer's printed name and officer title below. See ISP98 Rules 1.09(a) (Defined Terms ("Signature")), 3.06(d) (Complying Medium of Presentation), and 4.07 (Required Signature on a Document).

[36] Annex B endnotes. The endnotes for Annex B address only those few aspects that are unique to the Annex B form of demand. Otherwise, it is modeled on Annex A, the endnotes for which are not repeated.

[37] Retraction or replacement standby. The applicable government regulation or contract may permit the applicant to arrange for a timely retraction of the notice of non-extension or for a replacement standby. If the standby also permits retraction of a non-extension notice, as suggested in endnote 19 (Retraction of non-extension notice), the required beneficiary statement might add that no retraction of the non-extension notice and no permitted replacement standby (or other equivalent security) has been timely provided.

[38] References to UCC Article 5. All references in these endnotes to UCC Article 5 are to the official text of Article 5 which was substantially revised in 1995 and promulgated by the Uniform Law Commissioners and the American Law Institute. Although all states and the District of Columbia have enacted a substantially identical version of UCC Article 5, some state enactments have re-numbered or re-lettered its sections and some have omitted or altered

particular subsections. Where the law of a particular state is at issue, the version enacted in that state should be consulted before relying on the section cited in these endnotes. See http://topics.law.cornell.edu/wex/table_ucc.

[39] Banking Regulations. The U.S. Office of the Comptroller of the Currency ("OCC") is an independent bureau of the U.S. Department of the Treasury established in 1863. It regulates and supervises national banks and Federal savings associations to ensure that they operate in a safe and sound manner and in compliance with all applicable laws.

Over the years, the OCC has issued extensive rulings on bank letters of credit. In 1996, after the 1995 revision of UCC Article 5, the OCC promulgated a comprehensive version of its interpretive ruling, which was designated as 12 C.F.R. § 7.1016, replacing earlier versions in the Code of Federal Regulations dating back to 1971. 12 C.F.R. § 7.1016 has been further amended several times to expressly recognize developments in practice rules, including ISP98.

Although not imposing requirements on the enforceability of a letter of credit, through 12 C.F.R. § 7.1016 the OCC has imposed safety and soundness standards for letters of credit. The regulation indicates that its scope applies to all independent undertakings, focusing on their documentary character and requiring that they be definite, limited in amount and duration, and that the issuer or confirmer be able to be reimbursed. It also addresses undertakings to honor by delivering an item of value, automatic extensions, undertakings for a bank's own account, requisite operational expertise, and documentation.

While 12 C.F.R. § 7.1016 is by its terms applicable only to national banks, its principles frequently appear in rules applied to financial institutions chartered under different authority. For example, under 12 C.F.R. § 28.13, a Federal branch or agency of a foreign bank is generally subject to the same regulations as if it were a national bank. Federal and state savings associations are subject to the OCC's regulation 12 C.F.R. § 160.120 and the Federal Deposit Insurance Corporation's regulation 12 C.F.R. § 390.267, respectively, both of which essentially track 12 C.F.R. § 7.1016.

Bank issued standby letters of credit are thus subject to regulatory restraints that have evolved to assure the safety and soundness of the banking system. Banking regulations are likely to evolve to address and sometimes prohibit or limit practices that are becoming or have become unsound. In developing requirements for standby letters of credit, government agencies should take bank regulatory restraints into account and avoid standby requirements that bank regulators might consider unsafe or unsound for bank issuers.

Topic VII

Tax Issues in Commercial Leasing

Basics & Non-Basic Tips for Leasing Lawyers

By

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BASIC AND NON-BASIC TAX TIPS FOR LEASING LAWYERS

Bradley T. Borden*

I. Introduction

Leases raise several tax issues. Attorneys advising landlords and tenants should be aware of the general tax aspects that affect leases. This paper covers federal income tax issues that attorneys should be aware of as they assist clients with negotiating and entering into leases. The topics range from basic tax treatment of rent payments to more complex tax accounting for prepaid and deferred rent payments to issues that arise in specific leasing and transactional contexts.

II. Tax Basics of Leasing

A lease is an arrangement that requires payment for the use of property. As such, the owner of property (lessor) grants another party (lessee) the right to use the property in exchange for consideration. Those respective transfers of value create tax consequences to both the lessor and the lessee. The general tax treatment of lease payments does not apply in the case of section 467 lease, as discussed below.

A. General Tax Treatment of Lessor

Rent is ordinary income to the lessor, when the lessor receives the rental payments. I.R.C. §§ 61(a)(5), 451. Therefore, a lessor must pay tax on rent received at ordinary income rates.

B. General Tax Treatment of Lessee

Lessees can deduct rental payments as an ordinary and necessary cost of doing business against ordinary income. I.R.C. § 162(a)(3). Lessees cannot, however, deduct prepaid rent currently. Instead, they must capitalize prepaid rent. I.R.C. § 263; Treas. Reg. § 1.263(a)-4. That means they cannot deduct prepaid rent currently. Instead, a lessee would deduct a portion of prepaid rent over the life of the lease. Treas. Reg. § 1.162-11 (providing that the purchaser of a leasehold may deduct an aliquot share of purchase price of lease each year over life of lease).

C. Asymmetry and Tax Treatment Mismatch

Because the general tax rules require the lessor to recognize income upon receipt of rent payments and require the lessee to capitalize prepaid rent and deduct it over the life of the lease, the general tax rules create asymmetry, or a reporting mismatch. That mismatch generally benefits the government with respect to prepaid rent because the government currently receives tax on rental income reported by the lessor, but the lessee deducts the rent expense over the life of the lease. The following table illustrates the potential tax-treatment mismatch of prepaid rent.

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General Tax Treatment of Prepaid Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$900,000	$0	$0	$0	$0
Lessor Gross Income	$900,000	$0	$0	$0	$0
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

If the lessor and lessee use different accounting methods, deferred rent can also create asymmetry and mismatch. For instance, a lessee who use the accrual method of accounting deducts rent over the life of the lease, regardless of when the rent is paid. A cash method lessee would, however, generally only recognize rental income when the rent is paid. Thus, the lessee may have current deductions under the accrual method, while the lessor defers rental income until rent is paid, in the case of deferred rent. The following table shows the potential tax-treatment mismatch that results from deferred rent.

General Tax Treatment of Deferred Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$0	$0	$0	$0	$900,000
Lessor Gross Income	$0	$0	$0	$0	$900,000
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

The mismatch that results from the general tax treatment of rent payments can create tension between the lessee and lessor. The lessee would like to have a current deduction, but the lessor would prefer to defer income recognition. If both lessor and lessee are accrual method taxpayers, then they should both report the accrual of rents at the same time. In such situations, the tension would relate to timing of the payment. The lessee would prefer to receive payments as the rental income accrues, and the lessor would prefer to defer payment as long as possible. Congress recognizes this tension exists between lessors and lessees and created a tax regime to leverage that tension to create self-policing system that allows lessors and lessees to work together to develop rental accrual schedules. The regime also provides the IRS authority to

determine accrual schedules if it finds that the accrual schedule used by the lessor and lessee is designed to avoid taxes.

III. Section 467 Leases

Congress enacted section 467 to eliminate tax-reporting mismatch caused by tax accounting rules and to harness tax-avoidance schemes that took advantage of that mismatch. Section 467 uses rental accrual rules to match when a lessee deducts rent payments with when lessor recognizes income. The application section 467 to two types of lease arrangements could be deemed by the lessor or lessee to be punitive, but outside those two types of arrangements, and within certain regulatory parameters, section 467 provides an opportunity for lessor and lessee to negotiate the timing of the rental deductions and income.

In the section 467 legislative history, Congress recognized that the mismatch of income recognition and deductions provided opportunities for lessors and lessees to time payments to defer income recognition and advance rental deductions. Congress particularly identified leases with "backloaded" or "stepped" rents. With such leases, an accrual method lessee could deduct rents as they accrued over the life of the lease, while a cash method lessor deferred income recognition until receipt of payment at the end of the lease. If the tax situation of the lessor and lessee differed significantly, they could time lease payments and accrual to minimize the overall tax effect of the lease. For instance, if the lessor had significant current and carryover operating losses, the lessor would be amenable to recognizing rental income currently. Thus, the lessor might agree to a prepaid or frontloaded rent. The lessee would still have to capitalize and amortize any prepaid or frontloaded rental payments but would be happy with earlier deductions.

In enacting section 467, Congress provided the IRS with a tool to challenge and recharacterize leases that were designed to avoid federal income tax or did not provide for adequate interest payments. It also includes a self-policing mechanism that draws upon the tension that exists between lessors and lessees. Under that self-policing mechanism, lessors and lessees self-police tax reporting. For instance, a lessor and lessee may create rental accrual schedule that does not necessarily track rental payments. The catch is that the lessor and lessee must include adequate interest on fixed rent and recognize tax aspects of rent payments at the same time, so the lessor recognizes rental income at same time lessee takes rental deduction.

The self-policing mechanism breaks down if the parties' tax situations differ. For instance, a tax-exempt lessor would not worry about front-loaded rental accrual, but a lessee with significant current taxable income would favor front-loaded rental accrual. Alternatively, a lessee may have considerable current losses and not need the current deduction and agree with a lessor that has significant current income to backloaded rental accrual. Congress recognized these possibilities and provides a mechanism for the IRS to curtail such arrangements.

The self-policing mechanism of section 467 provides generally that if section 467 applies, the lessor and lessee must treat rents in the same manner, i.e., recognize the income and take the deductions at the same time. Additionally, the lessor and lessee must use the accrual method of accounting, regardless of their overall methods of accounting.

A. Applicability of Section 467

Section 467 only applies to "section 467 rental agreements." I.R.C. § 467(a); Treas. Reg. § 1.467-1(a)(2). The definition of section 467 rental agreement has two elements:

1. The agreement is for the use of tangible property, and
2. The agreement provides for
    a. Uneven (increasing or decreasing) rents, or
    b. Prepaid or deferred rent.

I.R.C. § 467(d)(1); Treas. Reg. § 1.467-1(c)(1). Agreements that provide for aggregate rents of less than $250,000 are excluded from the definition of section 467 rental agreements. I.R.C. § 467(d)(2); Treas. Reg. § 1.467-1(a)(2).

If section 467 applies, one of the section 467 rental accrual methods determines the amount of the lessor's rental income and the lessee's rental deduction for any taxable year. The section 467 accrual methods are:

1. The constant accrual method, Treas. Reg. § 1.467-1(e)(2)(i), -3,
2. The proportional accrual method, Treas. Reg. § 1.467-1(e)(2)(ii), -2, and
3. Rental agreement accrual method, Treas. Reg. § 1.467-1(e)(2)(iii).

The methods are mutually exclusive, so only one method will apply to a section 467 lease agreement. The applicable method determines the amount of fixed rent for each period of a lease, which becomes part of the section 467 rent that the lessor and lessee must account for in a given accrual period. Treas. Reg. § 1.467-1(b), -1(d)(1). Thus, in analyzing the different accrual methods, the focus is on which method applies to a particular section 467 rental agreement and determining the result of applying a particular method to an agreement.

B. Constant Rental Accrual Method

The constant rental accrual method applies to disqualified leasebacks and long-term agreements that do not provide for permissible accruals. I.R.C. § 467(b)(2), (3); Treas. Reg. § 1.467-1(d)(2)(i). Only the IRS can determine if lease is disqualified, so only the IRS can apply the constant rental accrual method. Stough v. Comm'r, 144 T.C. 306 (2015); Treas. Reg. § 1.467-3(a). A section 467 rental agreement is a disqualified if it (1) is either a leaseback or a long-term agreement, (2) the principal purpose of increasing or decreasing rents is the avoidance federal income tax, and (3) the IRS determines the leaseback or long-term agreement should be disqualified. I.R.C. § 467(b)(4); Treas. Reg. § 1.467-3(b)(1).

1. Leaseback or Long-Term Lease

A rental agreement is a leaseback if the lessee had any interest in the property at any time during the two-year period that ends on the date of the agreement. Treas. Reg. § 1.467-3(b)(2). A rental agreement is long-term if the lease term exceeds 75% of the property's statutory recovery period. I.R.C. § 467(b)(4)(A); Treas. Reg. § 1.467-3(b)(3)(i). The statutory recovery period of most real property, including land (which does not qualify for the depreciation deduction), is 19 years. Treas. Reg. § 1.467-3(b)(3)(ii). Thus, a rental agreement of real property is long-term if it runs for more than 14.25 years (19 × 75%).

2. Tax-Avoidance Purpose

The IRS will apply a facts and circumstances test to determine whether increasing or decreasing rents in an agreement have the principal purpose of avoidance of federal income tax. Treas. Reg. § 1.467-3(c)(1). The regulations provide safe harbors that show tax avoidance is not a principal purpose for increasing or decreasing rents, but failure to come within one of the safe harbors does not, by itself, indicate the agreement had a principal tax avoidance purpose. *Id.* The IRS will closely scrutinize any arrangement if the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term to be significantly different. Treas. Reg. § 1.467-3(c)(2)(i). The difference in marginal rates is significant if, in the case of an agreement with increasing rents, the lessor's marginal tax rate is expected to exceed the lessee's marginal tax rate by 10 percentage points during the lease term. Treas. Reg. § 1.467-3(c)(2)(ii)(A). In the case of a lease agreement with decreasing rents, the difference in marginal tax rates is significant if the lessor's marginal tax rate is expected to be more than 10 percentage points greater than the lessee's. Treas. Reg. § 1.467-3(c)(2)(ii)(B). In such situations, the lessor or lessee under scrutiny will have to show by clear and convincing evidence that the rental agreement did not have tax avoidance as a principal purpose. Treas. Reg. § 1.467-3(c)(2)(i).

The following are examples of when the difference between the lessor's and lessee's marginal tax rates might be significant.

1. The lessor is a tax-exempt entity, the taxable lessee has significant income, and the rental agreement provides for decreasing rents. In such a situation, the lessor does not pay tax on prepaid rent, and the lessee benefits from current deductions.
2. The lessee has current and projected operating losses, the lessor has significant income, and the rental agreement provides for increasing rents. In such situation, the lessor benefits from deferral of income recognition, and the lessee is indifferent about not getting deductions currently

Increasing or decreasing rents in these situations would appear to be in a rental agreement for the principal purpose of avoiding federal income tax, and the IRS would most likely scrutinize such arrangements.

3. Non-Avoidance Safe Harbors

The following situations come with the non-avoidance safe harbors. IRC § 467(b)(5); Treas. Reg. § 1.467-3(b)(3). Under the safe harbor, tax avoidance is not a principal purpose if increasing or decreasing rents meet the uneven rent test. Treas. Reg. § 1.467-3(c)(3)(i). Rents meet the uneven rent test if the amount of rent allocated to each calendar year is within 10 percent of the average rent for all calendar years. Treas. Reg. § 1.467-3(c)(4). An agreement also comes within the safe harbor if an increase or decrease in rent is wholly attributable to one or more of the following: (1) a contingent rent provision or (2) a single rent holiday allowing reduced rent for one consecutive period of the lease for less than three months or for a commercially reasonable period that cannot be in excess of the lesser of 24 months and 10 percent of the lease term. Treas. Reg. § .1467-3(b)(3)(ii).

4. IRS Application of the Constant Rental Accrual Method

If the IRS determines that the constant rental accrual method applies, the constant rental amount equals that amount the provides a present value equal to the present value of all amounts payable under the lease. Treas. Reg. § 1.467-3(d)(1). The IRS deploys a three-step process to compute a constant rental amount:

Step 1: determine present value of amounts payable under disqualified lease;
Step 2: determine present value of $1 to be received at end of each rental period; and
Step 3: divide Step 1 amount by Step 2 amount.

Treas. Reg. § 1.467-3(d)(3). The result of the process is the fixed rent for each accrual period of the lease. Treas. Reg. § 1.467-1(d)(2)(i). Example 1 illustrates the application of the steps to determine the constant rental amount.

Example 1: Application of the Constant Rental Accrual Method. The IRS determines that a rental agreement is a disqualified sale-leaseback. The rental agreement provides for deferred rent, and the lessor's marginal tax rate exceeds the lessee's marginal tax rate by a significant amount. The lease agreement includes the following payment schedule for year-end payments:

Schedule of Rent Payments due under Agreement					
	Year 1	Year 2	Year 3	Year 4	Year 5
Rent	$0	$0	$0	$17,500,000	$17,500,000

The IRS would deploy the three-step process to determine the constant rental amount.

Step 1: Determine the present value of rent payments (assumes a 12% applicable rate).

$$\$21{,}051{,}536 = \frac{\$0}{(1.12)^1} + \frac{\$0}{(1.12)^2} + \frac{\$0}{(1.12)^3} + \frac{\$17{,}500{,}000}{(1.12)^4} + \frac{\$17{,}500{,}000}{(1.12)^5}$$

Step 2: Determine the present value of $1 received at end of each rental period.

$$\$3.6047762 = \frac{\$1}{(1.12)^1} + \frac{\$1}{(1.12)^2} + \frac{\$1}{(1.12)^3} + \frac{\$1}{(1.12)^4} + \frac{\$1}{(1.12)^5}$$

Step 3: Determine the constant rental amount by dividing the Step 1 amount by the Step 2 amount.

$$\$\mathbf{5{,}839{,}910} = \frac{\$21{,}051{,}536}{\$3.6047762}$$

Because $5,839,910 is the constant rental amount, the lessor must report $5,839,901 as gross income for each year of the lease, and the lessee may deduct the same amount as rent expense for each year of lease. Treas. Reg. § 1.467-3(e), Ex. 6.

The application of the constant rental accrual method also results in a section 467 loan. The discussion below illustrates how to compute the loan amount and the interest imputed under a section 467 loan. A section 467 loan is a deemed loan, and it can be from either the lessor or the lessee. In this situation, because the rent payments are deferred, the lessor will be deemed to loan the money to the lessee and will have interest income over the life of the lease.

C. Section 467 Proportional Rental Accrual Method

The proportional rental accrual method can only apply if a section 467 rental agreement is not subject to the constant rental accrual method. Treas. Reg. § 1.467-1(d)(2)(ii). Thus, the proportional rental accrual method cannot apply to a section 467 rental agreement that the IRS determines is a disqualified leaseback or long-term agreement. Treas. Reg. § 1.467-2(a)(1). The rental agreement also must fail to provide for adequate interest on fixed rent. Treas. Reg. § 1.467-2(a)(2). The proportional rental accrual method would generally apply only if the payment schedule under the rental agreement differs from the accrual schedule in the rental agreement.

After determining that a rental agreement is not a disqualified leaseback or long-term lease, the next step in applying the proportional rental accrual method is to determine whether the rental agreement provides for adequate interest on fixed rent. If not, the parties must compute the proportional rental amount.

1. Adequate Interest on Fixed Rent

A section 467 rental agreement fails to provide for adequate interest on fixed rent, if it does not satisfy one of the definitions of adequate interest on fixed rent. A rental agreement provides for adequate interest on fixed rent if it that has no deferred or prepaid rent. Treas. Reg. § 1.467-2(b)(1)(i). Other agreements can provide for adequate interest on fixed rent in one of multiple different ways, depending upon the type of rent provided for in the rental agreement.

A section 467 rental agreement with deferred or prepaid rent provides adequate interest on the fixed rent if the rental agreement provides for interest on deferred or prepaid rent at a single rate, includes a stated rate of interest that is no lower than 110% of AFR, adjusts the amount of deferred and prepaid fixed rent at least annually to reflect amounts paid and owing, and requires interest to be paid or compounded at least annually. Treas. Reg. § 1.467-2(b)(1)(ii).

A section 467 rental agreement with deferred, but not prepaid, rent provides for adequate interest on fixed rent if the sum of the present value of all amounts payable by the lessee as fixed rent and interest is greater than or equal to the sum of the present value of the fixed rent allocated to each rental period. Treas. Reg. § 1.467-2(b)(1)(iii).

A section 467 rental agreement with prepaid, but no deferred, rent provides for adequate interest on fixed rent if the sum of the present value of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is less than or equal to the sum of the present value of fixed rent allocated to each rental period. Treas. Reg. § 1.467-2(b)(1)(iv).

A section 467 agreements with variable interest must use fixed rate substitutes to determine if it provides for fixed rates of interest. Treas. Reg. § 1.467-2(b)(2).

A section 467 agreement with both deferred and prepaid rent provides for adequate interest if the agreement satisfies the requirements of a rental agreement with deferred or prepaid rent, has a single fixed rate of interest on deferred rent, and has a single fixed rate of interest on

prepaid rent. The rates of interest on prepaid and deferred rent can differ. Treas. Reg. § 1.467-2(b)(3).

2. Computation of Proportional Rental Amount

If a section 467 rental agreements is not a disqualified leaseback or long-term lease and does not provide for adequate interest, the proportional rental amount is determined by multiplying the rent allocated to a rental period by the following fraction:

$$\frac{present\ value\ of\ amounts\ payable + interest}{present\ values\ of\ fixed\ rents\ allocated\ to\ each\ period}$$

Treas. Reg. § 1.467-2(c)(1).

3. Application of Proportional Rental Accrual Method

Example 2 illustrate the application of the proportional rental accrual method.

Example 2: Application of the Proportional Rental Accrual Method. A rental agreement that does not provide for an interest rate at a fixed rate has the following schedule of rent payments and allocations of rent.

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	Year 2	Year 3
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000

This agreement provides for deferred rent (rent paid only in Year 3), but not prepaid rent. Thus, it will have adequate interest if the sum of the present values of all amounts payable are greater than the sum of the present values of the fixed rent allocated to each rental period. Because the total rent allocated to each period equals the rent payable and some of the rent is allocated to Year 1 and Year 2, the sum of the present values of the rent allocated will exceed the present value of the rent payable. The computation of the present value proves out that conclusion. Assuming an applicable rate of 8.5%.

$$present\ value\ of\ amount\ payable = \$2{,}348{,}724 = \frac{\$3{,}000{,}000}{(1.085)^3}$$

$$present\ value\ of allocated\ rent = \$2{,}526{,}272 = \frac{\$3{,}000{,}000}{(1.085)^3}$$

Notice that $2,526,272 present value of the allocated rent is greater than the $2,348,724 of present value of rent payables. Thus, the following fraction would apply in determining the rent allocated to each period to compute the proportional rental amount for each rental period.

$$Fraction = .\mathbf{9297294} = \frac{\$2{,}348{,}724}{\$2{,}536{,}272}$$

The proportional rental amount for each rental period equals the rent allocated to each period multiplied by that fraction.

Year 1: $\$800{,}000 \times .9297294 = \$743{,}776$
Year 2: $\$1{,}000{,}000 \times .9297294 = \$929{,}729$
Year 3: $\$1{,}200{,}000 \times .9297294 = \$1{,}115{,}663$

Treas. Reg. § 1.467-2(f), Ex. 3.

As with the constant rental accrual method, the proportional rental accrual method results in a section 467 loan.

D. Section 467 Loans

The section 467 loan rules apply to rental agreements that are subject to either constant rental accrual method or proportional rental accrual method. Treas. Reg. § 1.467-4(a)(2), (3). A section 467 loan exists if, as of the first day of the rental period, the amount of fixed rent stated in the agreement differs from the amount determined under one of those methods. Treas. Reg. § 1.467-4(a)(1).

1. Principal Balance and Effect of Section 467 Loan

A section 467 loan can have either a positive principal balance or negative principal balance. Treas. Reg. § 1.467-4(a)(1). If a section 467 loan has a positive principal balance, it is a loan from lessor to lessee, so the lessor is deemed to be lending lessee accrued unpaid rent. Under such a situation, the lessor has interest income, and the lessee has interest expense. Treas. Reg. § 1.467-1(e)(3). If a section 467 loan has a negative principal balance, the loan is deemed to be from lessee to lessor, so the lessee is deemed to be lending lessor prepaid rent. Under such a situation, the lessee has interest income, and the lessor has interest expense. Treas. Reg. § 1.467-1(e)(3).

2. Computation of Section 467 Loan Principal Balance

The principal balance of a section 467 loan at the beginning of a rental period is determined using the following formula: fixed rent accrued in preceding years + (lessor's interest income for preceding years + interest payable to lessor on or before first day) – (lessee's interest income on prepaid fixed rent for prior rental periods + amount payable to lessor before first day as interest). Treas. Reg. § 1.467-4(b). Example 3 draws upon the facts in Example 2 to illustrate how to determine the amount of a section 467 loan.

Example 3: Computation of Section 467 Loan and Interest. The section 467 rental agreement in Example 2 required the application of the proportional rental accrual method to

determine the fixed rent for each rental period. The following table summarizes the result of the application of that method.

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	Year 2	Year 3
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000
467 Rent	$743,776	$929,729	$1,115,663

Using this information, the parties can determine the amount of section 467 loan outstanding at the beginning of each rental period and the amount of interest that will accrue on that loan. At the beginning of Year 1, no rent had accrued because the Year 1 rent accrues at the end of the year. At the beginning of Year 2, the accrued rent will equal $743,776. Assuming an 8.5% yield, the lessor will have interest income of $63,221 in Year 2, and the lessee will have an interest expense in the same year.

At the beginning of Year 3, the $1,736,726 outstanding balance will include the $743,776 of Year 1 rent, the $63,221 of Year 2 interest, and the $929,729 of Year 2 rent. The Year 3 interest on that amount will be $147,622. The outstanding balance increases by that amount of interest and the $1,115,663 of Year 3 rent to $3,000,000, as summarized in the following table.

Amount of 467 Loan + Interest (assume 8.5% yield)			
	Year 1	Year 2	Year 3
Accrued Fixed Rent (beginning)	$0	$743,776	$1,736,726
Lessor's Interest Inc.	$0	$63,221	$147,622
Interest Payable to Lessor	$0	$0	$0
Lessee's Interest	$0	$0	$0
Amount Payable to Lessor	$0	$0	$0
Outstanding Loan Balance (end)	$0	$806,997	$1,884,348
Ending Loan Balance			$3,000,000

Because the loan has a positive principal balance, its from the lessor to the lessee. The lessor therefore has $63,221 of interest income in Year 2 and $147,622 of interest income in Year 3, and the lessee has the same of amounts of interest expense in those years. The rules thus treat the lessor as lending the amount of section 467 rent to the lessee, treats the lessee as paying the rent to the lessor, and, at the end of the rental agreement, the lessee pays the principal and outstanding balance of the loan to the lessor.

E. Section 467 Rental Agreement Accrual Method

The section 467 rental agreement accrual method only applies if lease not subject to constant rental accrual method or proportional rental accrual. Treas. Reg. § 1.467-1(d)(2)(iii).

Thus, the rental agreement must provide adequate interest on fixed rent, and the rental agreement cannot be for disqualified leaseback or long-term lease. If a section 467 lease agreement qualifies for the rental agreement accrual method, tax law will follow accrual schedule in rental agreement. IRC § 467(b)(1). A rental agreement specifically allocates fixed rent to a rental period if it unambiguously specifies a fixed amount of rent for which the lessee becomes liable for use of the property during the period, and the total amount of fixed rent specified equals the total amount fixed rent payable under the lease. Treas. Reg. § 1.467-1(c)(2)(ii)(A)(*2*). If there is no specific allocation, the amount of rental allocated to a rental period is the amount of fixed rent payable during that rental period. Treas. Reg. § 1.467-1(c)(2)(ii)(B).

This method allows parties to a section 467 rental agreement to create the rental accrual schedule. They could frontload rent payments and backload accrual or backload payments and frontload accrual. If the structure does not have tax avoidance as the principal purpose, then the IRS would not be able to apply the constant rental accrual method. If the agreement had adequate interest on fixed rent, then the constant rental accrual method would not apply. Thus, the parties must take into account their respective preferences for recognizing income and taking deductions, compare their tax rates and account for the time value of money when schedule payments and rent accruals. These factors create some parameters, but do not prohibit the parties from allocating rents in values that differ from payments of rents. This fact is manifest in Example 2, which applies the constant rental accrual method. The parties to the rental agreement in that example should have been able to use the resulting accrual schedule to allocate rents, and the agreement should have had adequate interest on fixed rent. The parties would, of course, have to account for the interest as well as the rent with such a schedule.

IV. Tax Treatment of Improvements to Leased Property

Improved leased property raises tax issues related to depreciation deductions of the property and to tax treatment of tenant improvements that revert to the lessee on termination of the lease.

A. Depreciation Deductions

Depreciation deductions are valuable because they reduce taxable income without affecting operating cash flow. As a general matter, the owner of property gets depreciation deductions. Therefore, the lessor typically gets depreciation deductions for improvements the lessor constructs on leased property. The lessee typically gets depreciation deductions for tenant improvements. In determining who gets the deprecation deductions, courts look to which party invested capital in the improvements. Hopkins Partners v. Comm’r, 97 T.C.M. (CCH) 1560 (2009).

B. Lessee Improvements

Generally, lessee improvements are excluded from lessor’s income upon lease termination when the improvements revert to the lessor. I.R.C. §§ 109, 1019.

A lessee must capitalize the cost of lessee improvements. I.R.C. § 263. Regardless of who qualifies for the depreciation deductions, the paying party must capitalize the cost of improvements and depreciate the cost over applicable MACRS recovery period—not life of

lease. I.R.C. § 168(i)(8)(A). Thus, if a lease has 25 years remaining, but the recovery period of property the lessee constructs is 39 years, a lessee must compute depreciation deductions related to tenant improvements over 39 years.

Tenant improvements can be a substitute for rent, in which case, the improvements give rise to lessor as ordinary rental income. The lessee can deduction cost of rent-substitute improvements currently against ordinary income, if the substitute improvements are for current rent. Hopkins Partners v. Comm'r, 97 T.C.M. (CCH) 1560 (2009); Treas. Reg. § 1.109-1.

V. Tax Classification of Leases

Leases are leases are leases . . . unless tax law classifies them as something else. Such reclassification is possible when an arrangement that is labeled a lease is substantively something different from a lease for tax purposes. Consider two possible reclassifications of leases—a reclassification to a sale or financing and a reclassification to a partnership.

A. Lease vs. Sale/Financing

A lease is a finance transaction. A lease provides the lessee the right to use property in exchange for making payments. As the discussion of section 467 illustrates, a lease with prepaid or deferred rent can create a loan with interest, at least for tax purposes. A lease also provides an asset and liability for each party to the lease. The lessor has a right to rental payments, and the lessee has a right to use the property. The lessor has an obligation to make the property available to the lessee, and the lessee has an obligation to pay rent. Sophisticated lessees and lessors will also recognize that deferred and prepaid rent have time-value-of-money implications. Thus, leases have attributes of many finance arrangements.

An arrangement that is labeled a lease may lack the attributes that make it a lease and begin to look like a sale from the lessor to the lessee or a financing arrangement with the lessor providing financing for the lessee to purchase the property. The structure of the former transaction would include the lessor leasing the property to the lessee, but the form may reflect a seller-financed transfer of the property. The structure of the latter transaction would represent the lessor acquiring property and leasing it to the lessee. In substance, such a transaction may be nothing more than the lessee providing financing for the lessee to acquire the property.

If the transaction is a seller-financed transfer, the "lessor" would realize gain at the inception of the arrangement (and most likely recognize the gain as payments are made under the installment method), and the "lessee" would take a basis in the property equal to is purchase price. Regular "lease" payments would be treated as debt service. Tax law looks at the substance of transactions to determine their proper classification.

Tax law generally recognizes that the party that holds the benefits and burdens of a property is the tax owner of the property. Courts consider the following several factors in determining who holds the benefits and burdens.

- How do the parties treat the transaction?
    - Rent payments or debt service and interest?
    - Lessor recognizes gain upon entering into the lease?
    - Which party is claiming depreciation deductions?
- Does the lessor have an equity interest in the property?
- Will the property have any economic value at the end of the lease term?

    - If the lessee consumes all of the property's economic value during the lease term, the lease looks more like a sale
- Does lessee have option to purchase at below market at end of lease term?
    - If the exercise price of the option is well below market, the rational lessee will exercise the option and acquire the property. The lessee may turn around and sell it immediately, but a low exercise price transfers benefits to the lessee.
- Does the lessor have a present obligation to transfer title to the property?
- Who bears the risk of loss?
- Who owns the upside?

Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Torres v. Commissioner, 88 T.C. 702, 720-722 (1987); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-1238 (1981); Estate of Thomas v. Commissioner, 84 T.C. 412, 433-436 (1985).

B. Lease vs. Partnership

The IRS could also find that something that the parties call a lease is actually a partnership. State law provides that a partnership is "an association of two or more persons to carry on as co-owners a business for profit." If rent is based upon the lessee's profits, the IRS may scrutinize the arrangement more closely. To avoid the risk of that scrutiny, the parties may prefer to base rent on gross receipts. The parties should also consider who the ultimate disposition of the property, which relates to ownership and co-ownership. The question of whether a partnership exists is one of the most difficult questions in partnership tax, if a situation raises the question. *See* Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925 (2006). The question is also a matter of federal tax law, so state law classification is not determinative.

VI. Synthetic Leases

Synthetic leases have been a popular finance structure for many years, but changes in GAAP may be dampening their attractiveness. The essence of a synthetic lease is that the user is treated as the owner of the property for tax purposes. For GAAP purposes, the arrangement is an operating lease, so the parties do not have to report liabilities in their financial statements. Synthetic leases are typically used for assets such as corporate headquarters, other real estate projects, or corporate aircraft. They are only relevant for parties who provide GAAP financial statements.

A. Financing structure

The lease documents of a synthetic least typically provide for a short-term lease (less than 10 years, including renewal options). The lease uses purchase options and rights of termination to shift the benefits and burdens of ownership to the lessee. For GAAP purposes the user is deemed to enter into an operating lease with the "lender."

VII. REITs and Rents

REIT income tests require that 95% (passive type income) and 75% (income from real property) of the REIT's gross income derive from specific sources, including Rents from real property. IRC § 856(c)(2), (3). For payments to come within the definition of rents from real property they must be for the use of real property. IRC § 856(d)(2). Numerous cases and rulings and recent regulations address the definition of real property. *See* Bradley T. Borden, *Reforming REIT Taxation (or Not)*, 53 HOUS. L. REV. 1 (2015); Treas. Reg. § 1.856-10.

For REIT purposes, rent excludes payment for services provided to tenants, other than customary services. IRC § 856(d)(1). Non-customary services can be provided to tenants of REIT property by independent contractors and taxable REIT subsidiaries. IRC § 856(d)(2)(C), (7).

VIII. Tax Treatment of Lease Termination Payments

A lease termination fee paid from a lessee to a lessor is ordinary income to the lessor. Hort v. Comm'r, 313 U.S. 28 (1941); Treas. Reg. § 1.61.8(b). The lessee should be able to deduct such a termination fee currently. Cassatt v. Comm'r, 137 F.2d 745 (3d Cir. 1943).

A lessor must capitalize a termination fee paid to a lessee. Treas. Reg. § 1.263(a)-4(d)(7)(i)(A). The lessor either adds the fee to the basis of the property, recovers it over the unexpired term of the terminated lease, or recovers it over another lease the lessor enters into in a transaction related to the termination. Handlery Hotels, Inc. v. United States, 663 F.2d 892 (9th Cir. 1981). The lessee treats the receipt of such a payment as an amount received in exchange for selling the lease. I.R.C. § 1241. The lessee's tax treatment will therefore depend upon whether the lease is a capital asset or business-use property for the lessee, which would result in capital gains or losses, or another type of asset, which would result in ordinary income.

IX. Use of Leases in Land-Building Splits

With land-building splits, the owner of improved property transfers title to a building on land and retains the land. The purchaser of the building uses the lease to obtain access to the land on which the building stands. Several cases have considered whether attempts to split buildings from land have been successful.

A. Unsuccessful Splits

Courts have provided a list of Indicia of lease, but no transfer of building in attempted land-building splits:

- Lessee required to restore destroyed building
- Lessee must post bond equal to demolition and construction costs to replace existing building
- Lessee required to insure building
- Recovery from loss of building paid to lessor
- Lessee must maintain the building in good condition
- Title to building reverts to lessor when lease terminates
- Lessee is not permitted to sever or remove the buildings

Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934); Lindley's Trust No. 1 v. Comm'r, 120 F.2d 998 (8th Cir. 1941); Crile v. Comm'r, 55 F.2d 804 (6th Cir. 1932); Estate of Budd Frankenfield v. Comm'r, 17 T.C. 1304 (1952); Minneapolis Syndicate v. Comm'r, 13 B.T.A. 1303 (1928).

B. Successful land-building splits

Perhaps the most common example of a land-building split is a condominium sale. The IRS has ruled that a land-building split was successful with respect to a condominium sale, in which the lessee had the right to remove the condominium at end of the ground lease, the lessor had to acquire units that were not removed at end of the lease, and the owner of the improvements would receive proceeds from condemnation. Rev. Rul. 70-607, 1970-2 C.B. 9. The tax court has held that the right to remove building is strong indication of split. Waldrep v. Comm'r, 52 T.C. 640 (1969). A federal district court has held that the right to remove building and a right to insurance proceeds are indicia of a split. Bratton v. Rountree, 37 A.F.T.R.2d 76-762 (M.D. Tenn. 1976).

One way to approach the land-building split question is to consider whether the building will have any value and remaining useful life at the end of the lease of term. If it does, and it will revert to the land owner, then the lessee would not appear to own the building. If the lessee will consume the useful life and value of the building, then it is more likely that lessee owns the building. Some buildings retain useful life for the decades, so they may have remaining useful life even after a 99-year lease expires.

X. Exchanging Leases under New Section 1031

Leases appear to qualify for like-kind exchange treatment under section 1031. Section 1031 requires relinquished and replacement property to be real property and like kind. IRC § 1031(a). Leasehold of a fee with 30 years or more to run is like kind to real estate. Treas. Reg. § 1.1031(a)-1(c)(2).

The real-property requirement in section 1031 became part of the law with the enactment of the Tax Cuts and Jobs Act of 2017 at the end of 2017. That new requirement raises the question of whether a leasehold in real property comes within the definition of real property under section 1031. Tax law recognizes that leases are intangible personal property for capitalization rules. Treas. Reg. § 1.263(a)-4(c)(1)(vi), -4(d)(3). But definitions of real property in other areas of tax law include leases. I.R.C. § 897(c)(6); Treas. Reg. § 1.1250-1(e)(3)(i); Treas. Reg. § 1.263A-8(c)(1).

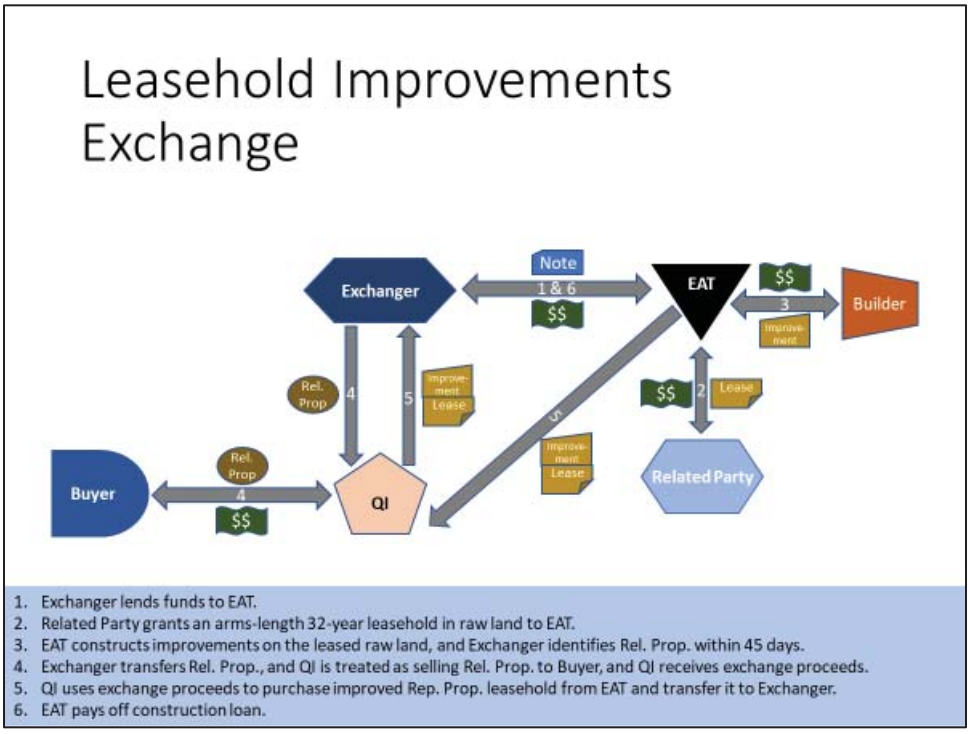
Even if a lease comes within the definition of real property, it must be like-kind to the exchange property to qualify for section 1031 tax-free treatment. The regulations provide that a leasehold in real property of at least 30 years is like kind to general interests in real property (i.e., land and improvements), but a leasehold in real property of less than 30 years probably is not like kind to general interests in real property. Standard Envelope Manufacturing Co. v. Commissioner, 15 T.C. 41 (1950); Capri, Inc. v. Commissioner, 65 T.C. 162 (1975). Such leases could, however, be like kind to other leases of similar length. Rev. Rul. 76-301, 1976-2 C.B. 241.

XI. Leasehold Improvement Situation

The leasehold improvement exchange is one of the most creative and useful exchange structures. Yet, many people are not aware of its availability. Such exchanges make sense when a property owner would like to sell property tax free and use the sale proceeds to construct improvements on other raw land the property owner holds. To qualify for section 1031 tax-free treatment, the transaction must be an exchange and the property acquired must be real property that is like-kind to the transferred property. The transaction must also properly address the related-party rules, if relevant.

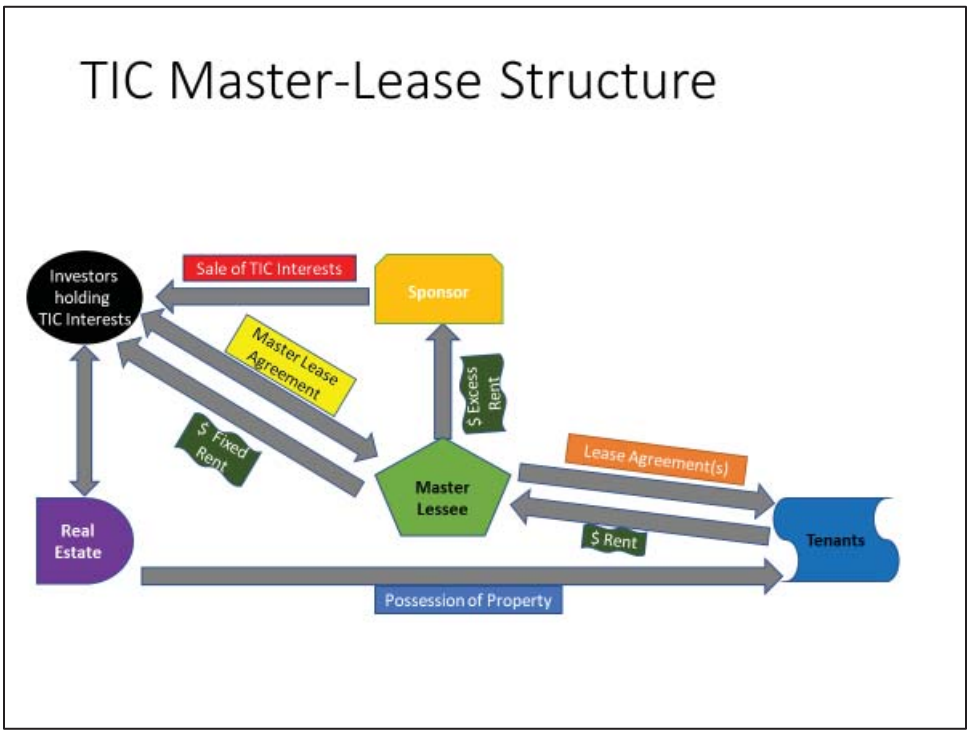
Property that property owner already owns is not eligible for a leasehold improvement exchange. An exchange requires a reciprocal transfer of property. Treas. Reg. § 1.1002-1(d). Therefore, a person cannot acquire already-owned property as part of an exchange, transfer of the property to an accommodation titleholder, and thereby cleanse the pre-owned status. Rev. Proc. 2004-51, 2004-2 C.B. 294. Another party, including a related party, must own the property for at least 180 days prior to the exchange to cleanse pre-owned status, but beware of the related party exchange rules.

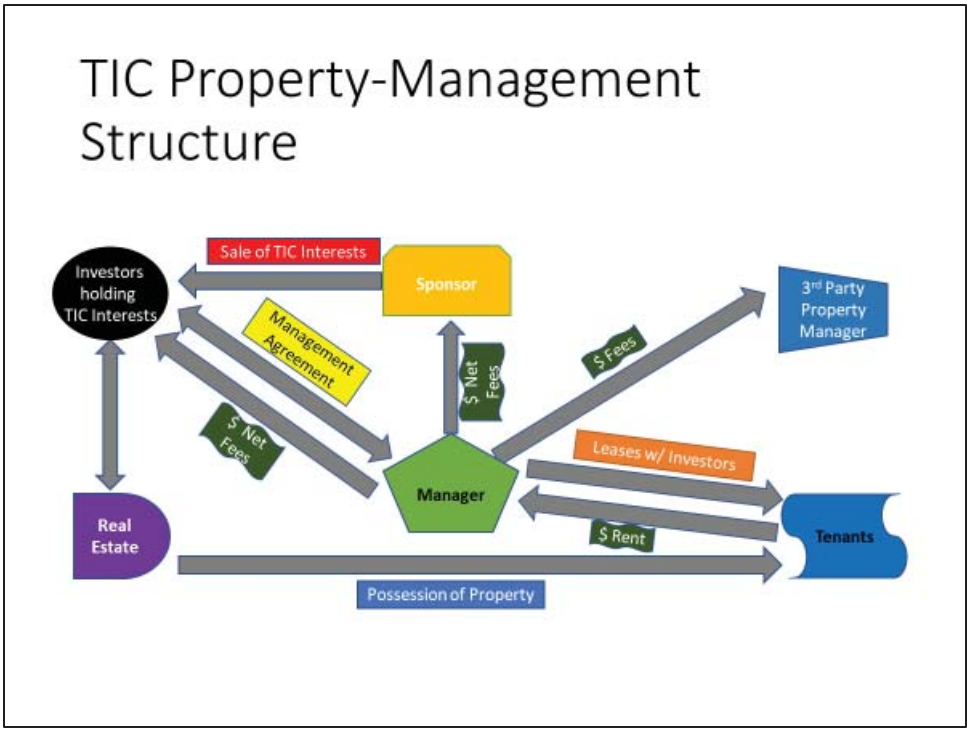
With those hurdles in mind, a property owner may try a leasehold improvements exchange. The property owner avoids building on its property by causing a related party to lease the raw land to an accommodation titleholder. While the accommodation titleholder is the lessee, the property owner directs the accommodation titleholder to construct improvements. Once the improvements are constructed, the accommodation titleholder transfers the leasehold to the property owner to complete the exchange. The IRS approved a leasehold improvement exchange in PLR 200251008, and it approved a similar structure in PLR 200329021. The diagram illustrates the leasehold improvements exchange.



XII. Use of Leases in TICs and DSTs (Lease as "Blocker")

Tenancy-in-common arrangements (TICs) and Delaware statutory trusts (DSTs) find use in the section area because property owners desire to directly own interests in real property instead of owning interests in a partnership. For members of TICs and DSTs to be treated as owning direct interests in the property, the TIC or DST cannot be classified as a partnership for tax purposes. The question of whether a TIC or DST is a tax partnership generally is a challenging question. To steer clear of partnership classification, TICs and DSTs must refrain from conducting business activity. Many such structures use master-lease arrangements to pass the management activities down to the master lessee and limit activity at the TIC and DST level to interacting with the master-lessee. The following diagrams illustrate the difference between a TIC with direct management of the property and one with a master-lessee.





The lease in the master-lease structure becomes a "blocker," blocking the activities associated with managing the property and working with tenants from being attributed to the TIC owners, if structured properly.

Basic and Non-Basic Tax Tips for Leasing Lawyers

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Presentation Overview

- Tax basics of leasing
- Section 467 leases
- Tax treatment of tenant improvement costs
- Identifying the party entitled to depreciation deductions in a ground lease of improved property
- When is a lease a sale and vice versa?
- End of synthetic leases?
- REIT rents problems
- Tax treatment of lease termination payments
- Use of leases in land-building splits
- Exchanging leases under new Section 1031
- Leasehold improvements exchanges
- Lease arrangements in TICs and DSTs

Tax Basics of Leasing

- Lessor has income when rent payment received
  - Rent is ordinary income
    - I.R.C. § 61(a)(5)/451
- Lessee cannot deduct prepaid rent currently
  - Must capitalize and deduct over life of lease
  - Rent is deductible against ordinary income (assuming property is used in trade or business)
    - I.R.C. § 263/Treas. Reg. § 1.263(a)-4
    - Treas. Reg. § 1.162-11 (aliquot share of purchase price of lease each year over life of lease)
- Rules create asymmetry
  - Lessor has income when rent payments received
  - Lessee must defer deductions
- Lessor-lessee tension
  - Lessee wants current deduction
  - Lessor wants to defer income recognition

Examples of Lessor-Lessee Tax-Reporting Mismatch and Tension

General Tax Treatment of Prepaid Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$900,000	$0	$0	$0	$0
Lessor Gross Income	$900,000	$0	$0	$0	$0
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

General Tax Treatment of Deferred Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$0	$0	$0	$0	$900,000
Lessor Gross Income	$0	$0	$0	$0	$900,000
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

Section 467

- Section 467 designed to eliminate mismatch caused by tax accounting rules
  - Require/allow lessee to deduct rent payments when lessor recognizes income
  - Enacted to help prevent abuse
    - Lease with “backloaded” or “stepped” rents
    - Accrual method lessee gets current deductions
    - Cash method lessor defers income recognition until later in lease
- Congress leverages lessor-lessee tension
  - Lessor and lessee self-police tax reporting
  - Lessor and lessee create rental accrual schedule that does not necessarily track payments of rent
  - Lessor and lessee must recognize tax aspects of rent payments at the same time
    - Lessor recognizes rental income at same time lessee takes deduction
- Self-policing mechanism breaks down if the parties’ tax situations differ
  - Tax-exempt lessor (doesn’t worry about front-loaded rent)
  - Lessee with considerable current losses (doesn’t need current deduction)
- If section 467 applies
  - Lessor and lessee must treat rents consistently
  - Lessor and lessee must use accrual method of accounting, regardless of overall method of accounting

Applicability of Section 467

- Applies to "section 467 rental agreements"
  - Lease of tangible property
    and
  - Rental terms
    - Uneven rents (increasing or decreasing)
      or
    - Prepaid or deferred rent
  - Provides for total rent of more than $250,000

- If section 467 applies, one of the section 467 rental accrual methods determines the amount of the lessor's rental income and the lessee's rental deduction for any taxable year

Section 467 Rental Accrual Methods

- Constant rental accrual method
  - Treas. Reg. § 1.467-1(e)(2)(i), -3
- Proportional rental accrual
  - Treas. Reg. § 1.467-1(e)(2)(ii), -2
- Rental agreement accrual
  - Treas. Reg. § 1.467-1(e)(2)(iii)

Section 467 Constant Rental Accrual Method

- Disqualified long-term agreement or leaseback
  - Leaseback if lessee held interest in property within two years prior to lease
  - Long-term lease if lease term exceeds 75% of the property's statutory recovery period
    - Real estate has a recovery period of 19 years for section 467
    - 19 × 75% = 14.25
      - All leases with terms exceeding 14.25 years are long-term under this definition
- Disqualified
  - Principal purpose for providing increasing or decreasing rent is the avoidance of federal income tax
  - IRS Commissioner determines the lease should be disqualified because of the tax avoidance purpose
    - Only IRS Commissioner can apply
      - Enforcement sword
      - Not a shield for taxpayers
- Creates a section 467 loan

Application of Constant Rental Accrual Method

- Tax avoidance
  - Reasonable expectation of significant difference between the marginal tax rates of the lessor and lessee at some time during lease term
  - Leads to close scrutiny of agreement
  - Need clear and convincing evidence to show tax avoidance not a principal purpose
- If IRS finds tax avoidance, it uses 3-step method to determine constant rental amount
  - Step 1: determine present value of amounts payable under disqualified lease
  - Step 2: determine present value of $1 to be received at end of each rental period
  - Step 3: divide Step 1 amount by Step 2 amount

Reasonable Expectation of Significant Difference in Marginal Tax Rates

- Rental agreement has increasing rents
  - Lessors marginal tax rate
    is expected to be greater than
  - Lessee's marginal tax rate + 10 percentage points
- Rental agreement has decreasing rents
  - Lessee's marginal tax rate
    is expected to be greater than
  - Lessor's marginal tax rate + 10 percentage points

Examples of Possible Significant Difference in Marginal Tax Rates

- Lessor is tax-exempt entity, taxable lessee has significant income
  - Lease provides for decreasing rents
    - Lessor does not pay tax on prepaid rent
    - Lessee benefits from current deductions
- Lessee has current and projected operating losses, lessor has significant income
  - Lease provides for increasing rents
    - Lessor benefits from deferral of income recognition
    - Lessee is indifferent about not getting deductions currently

Computation of Constant Rental Amount

- Disqualified sale-leaseback (lessor has higher tax rate)

Schedule of Rent Payments due under Agreement					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Rent	$0	$0	$0	$17,500,000	$17,500,000

  - Step 1: present value of rent payments = $21,051,536
    - Assumption: 12% discount rate
  - Step 2: present value of $1 received at end of each rental period = $3.6047762
  - Step 3: $\frac{\$21,051,536}{\$3.6047762} = \mathbf{\$5,839,901}$ (fixed rent for each rental period)
- Lessor must report $5,839,901 as gross income for each year of lease
- Lessee may deduct $5,839,901 as rent expense for each year of lease

Safe Harbor from Constant Rental Amount

- Tax avoidance not a principal purpose for increasing or decreasing rents if
  - Meet uneven rent test
    - Amount of rent allocated to each calendar year is within 10 percent of the average rent for all calendar years
  - Increase or decrease in rent is wholly attributable to one or more of the following
    - A contingent rent provision
    - A single rent holiday allowing reduced rent for one consecutive period of the lease
      - For three months or less
      - Reasonable, as determined by reference to commercial practice
      - Does not exceed lesser of 24 months and 10 percent of lease term

Section 467 Proportional Rental Accrual Method

- Only applies if rental agreement is not subject to constant rental accrual method
  - Section 467 rental agreement is not a disqualified leaseback or long-term agreement
- Rental agreement provides for
  - Does not provide for adequate interest
- Generally, applied if payment schedule under the lease is different from the accrual schedule
- Creates a section 467 loan

Adequate Interest on Rent

- Adequate interest on fixed rent
  - No deferred or prepaid rent
  - Deferred or prepaid rent, and
    - Rental agreement provides for interest on deferred or prepaid rent at a single rate
    - Stated rate of interest is no lower than 110% of AFR
    - Amount of deferred and prepaid fixed rent adjusted at least annually to reflect amounts paid and owing
    - Rental agreement requires interest to be paid or compounded at least annually
  - Other agreements
    - Deferred, but no prepaid, rent
      - Sum of present value of all amounts payable by lessee as fixed rent is greater than or equal to the sum of the present value of the fixed rent allocated to each rental period
    - Prepaid, but no deferred, rent
      - Sum of present value of all amounts payable by lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is less than or equal to the sum of the present value of fixed rent allocated to each rental period
- Section 467 rental agreements with variable interest
  - Use fixed rate substitutes
- Agreement with both deferred and prepaid rent
  - Satisfy the requirements of a rental agreement with deferred or prepaid rent
  - Single fixed rate of interest on deferred rent
  - Single fixed rate of interest on prepaid rent
  - Rates of interest can differ

Computation of Proportional Rental Amount

- For rental agreements that are not disqualified and do not provide for adequate interest the proportional rental amount is the amount of rent allocated to rental period multiplied by the following fraction:

$$\frac{present\ values\ of\ amounts\ payable + interest}{present\ values\ of\ fixed\ rents\ allocated\ to\ each\ period}$$

Application of Proportional Rental Accrual Method

- Rent schedule in agreement

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	**Year 2**	**Year 3**
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000

- Agreement does not state adequate interest
  - Has deferred rent
  - Does not provide for interest at a fixed rate
  - Present value of payments not greater than or equal to present value of allocated rents (assuming 8.5% discount rate)
    - Present value of amounts payable = $2,348,724
    - Present value of allocated rents = $2,526,272
- Fraction = $2,348,724/$2,526,27 = .9297294
- Section 467 rent for each year
  - Year 1: $800,000 × .9297194 = $743,776
  - Year 2: $1,000,000 × .9297194 = $929,729
  - Year 3: $1,200,000 × .9297194 = $1,115,663
- Parties must also account for interest on the section 467 loan

Section 467 Loans

- Section 467 loan exists if rent is determined using either constant rental accrual method or proportional rental accrual method
  - I.e., the amount of fixed rent stated in the agreement differs from the amount determined under one of those methods
- Positive section 467 principal balance
  - Loan from lessor to lessee
    - Lessor is lending lessee accrued unpaid rent
  - Lessor has interest income
  - Lessee has interest deduction
- Negative section 467 principal balance
  - Loan from lessee to lessor
    - Lessee is lending lessor prepaid rent
  - Lessee has interest income
  - Lessor has interest deduction

Computation of Section 467 Loan

Amount of 467 loan = Fixed rent accrued in preceding years + (lessor's interest income for preceding years + interest payable to lessor on or before first day) – (lessee's interest in income on prepaid fixed rent for prior rental periods + amount payable to lessor before first day as interest)

- Example from proportion accrual method

Schedule of Rent Allocated and Payments due under Agreement			
	Year 1	**Year 2**	**Year 3**
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000
467 Rent	$743,776	$929,729	$1,115,663

Amount of 467 Loan + Interest (assume 8.5% yield)			
	Year 1	**Year 2**	**Year 3**
Accrued Fixed Rent (beginning)	$0	$743,776	$1,736,726
Lessor's Interest Inc.	$0	$63,221	$147,622
Interest Payable to Lessor	$0	$0	$0
Lessee's Interest	$0	$0	$0
Amount Payable to Lessor	$0	$0	$0
Outstanding Loan Balance	$0	$806,997	$1,884,348
Ending Loan Balance			$3,000,000

Section 467 Rental Agreement Accrual Method

- Only applies if lease not subject to constant rental accrual method or proportional rental accrual
- Follow accrual schedule in rental agreement
- If there is no specific allocation, the amount of rental allocated to a rental period is the amount of fixed rent payable during that rental period

Depreciation Deductions Related to Leased Property

- General rule: owner of property gets depreciation deductions
  - Lessor typically gets depreciation deductions for improvements lessor constructs on leased property
  - Lessee typically gets depreciation deductions for tenant improvements
  - Look to who invested capital in the improvements
- Lessee improvements
  - Lessee improvements excluded from lessor's income upon lease termination
    - I.R.C. §§ 109, 1019
  - Lessee must capitalize cost of lessee improvements
    - I.R.C. § 263
  - Lessee or lessor capitalizes and depreciates cost of improvements over applicable MACRS recovery period—not life of lease
    - I.R.C. § 168(i)(8)(A)
- Tenant improvements as substitute for rent
  - Lessee improvements are in lessor's income, if a substitute for rent
  - Lessee can deduction cost of rent-substitute improvements currently
    - Hopkins Partners v. Comm'r, 97 T.C.M. (CCH) 1560 (2009); Treas. Reg. § 1.109-1

Lease vs. Sale/Financing

- Tax law can disregard the form of a transaction
  - Transaction cast as a lease can be a seller-financed sale from the lessor to the lessee in substance
  - Transaction cast as a debt-financed purchase by the user could be recast as a purchase by the "lender" and lease to user
- Party that holds the benefits and burdens is the tax owner
  - Factors
    - How do the parties treat the transaction?
      - Rent payments or debt service and interest?
      - Lessor recognize gain upon entering into the lease?
      - Which party is claiming depreciation deductions?
    - Does the lessor have an equity interest in the property?
      - Will the property have any economic value at the end of the lease term?
      - Does lessee have option to purchase at below market at end of lease term?
      - Does the lessor have a present obligation to transfer title to the property?
    - Who bears the risk of loss?
    - Who owns the upside?

- *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Torres v. Commissioner*, 88 T.C. 702, 720-722 (1987); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-1238 (1981); *Estate of Thomas v. Commissioner*, 84 T.C. 412, 433-436 (1985)

Lease vs. Partnership

- Partnership under state law: “an association of two or more persons to carry on as co-owners a business for profit”
  - Is “rent” based upon lessee’s profits?
    - Different if gross receipts?
  - Who controls the ultimate disposition of the property?

- Question of whether a partnership exists is one of the most difficult questions in partnership tax, if a situation raises the question
- Question is matter of federal tax law, so state law classification is not determinative

Synthetic Leases

- Financing structure
  - Short-term lease (<10 years, including renewal options)
  - Purchase options
  - Rights of termination
  - Relevant to taxpayers who prepare GAAP financial statements
  - Used for assets such as corporate headquarters or real estate projects, or corporate aircraft
- For tax purposes, the user is deemed to borrow and buy property
  - User has the benefits and burdens
  - User gets the depreciation deductions
- For GAAP purposes the user is deemed to enter into an operating lease with the "lender"
  - Operating lease keeps the obligation for rent payments off the balance sheet
- Recent accounting changes will require lessees to record a lease liability for synthetic leases, so benefit of off-balance sheet finance will be lost
  - Popularity may diminish

REITs and Rents

- REIT income tests require that 95% (passive type income) and 75% (income from real property) of the REIT's gross income derive from specific sources, including
  - Rents from real property

- Rents from real property
  - Must be real property
    - Numerous rulings and recent regulations
  - Must be rent
    - Cannot be from services provided to tenants, other than customary services
  - Non-customary services can be provided to tenants by
    - Independent contractors
    - Taxable REIT subsidiaries

Tax Treatment of Lease Termination Payments

- Treatment of termination fee paid from lessee to lessor
  - Ordinary income to lessor
    - Hort v. Comm'r, 313 U.S. 28 (1941)
    - Treas. Reg. § 1.61.8(b)
  - Lessee should be able to currently deduct fee
    - Cassatt v. Comm'r, 137 F.2d 745 (3d Cir. 1943)
- Treatment of termination fee paid from lessor to lessee
  - Lessor must capitalize fee, Treas. Reg. § 1.263(a)-4(d)(7)(i)(A)
    - Add to basis of the property
    - Recover over unexpired term, or
    - Recover over another lease the lessor enters into
      - Handlery Hotels, Inc. v. United States, 663 F.2d 892 (9th Cir. 1981)
  - Lessee treats payment as an amount received in exchange for selling the lease
    - I.R.C. § 1241

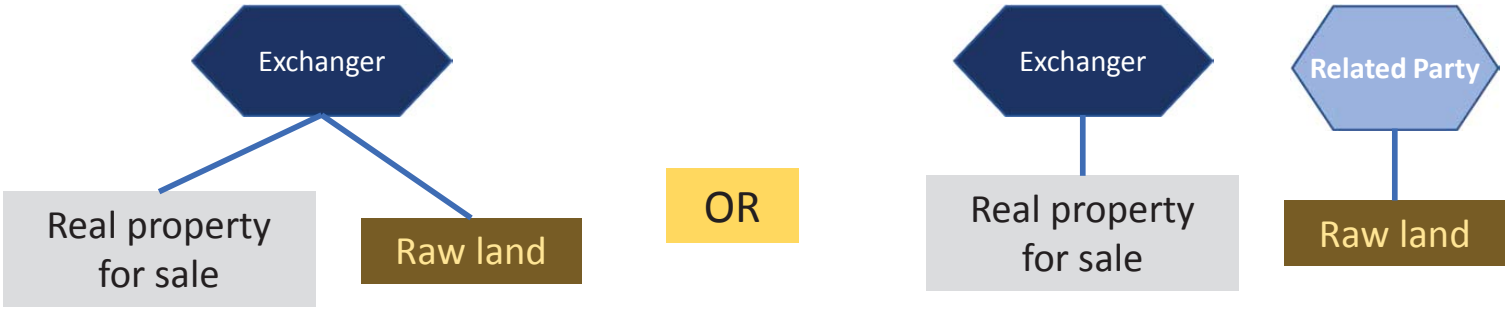
Use of Leases in Land-Building Splits

- Land-building split: owner of improved property transfers title to building and retains land
  - Purchaser of building uses lease for access to the land
- Indicia of lease, but no transfer of building (unsuccessful splits)
  - Lessee required to restore destroyed building
  - Lessee must post bond equal to demolition and construction costs to replace existing building
  - Lessee required to insure building
  - Recovery from loss of building paid to lessor
  - Lessee must maintain the building in good condition
  - Title to building reverts to lessor when lease terminates
  - Lessee is not permitted to sever or remove the buildings
    - Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934); Lindley's Trust No. 1 v. Comm'r, 120 F.2d 998 (8th Cir. 1941); Crile v. Comm'r, 55 F.2d 804 (6th Cir. 1932); Estate of Budd Frankenfield v. Comm'r, 17 T.C. 1304 (1952); Minneapolis Syndicate v. Comm'r, 13 B.T.A. 1303 (1928).
- Successful land-building splits
  - Condominium sales
    - Lessee has right to remove at end of ground lease
    - Lessor had to acquire units that were not removed at end of the lease
    - Owner of improvements would receive proceeds from condemnation
      - Rev. Ru. 70-607, 1970-2 C.B. 9
  - Right to remove building strong indication of split
    - Waldrep v. Comm'r, 52 T.C. 640 (1969)
  - Right to remove building and right to insurance proceeds indicia of split
    - Bratton v. Rountree, 37 A.F.T.R.2d 76-762 (M.D. Tenn. 1976)

Exchanging Leases under New Section 1031

- Section 1031 requires relinquished and replacement property to be real property and like kind
- Leasehold of a fee with 30 years or more to run is like kind to real estate
  - Treas. Reg. § 1.1031(a)-1(c)(2)
- Is a leasehold in real property real property under section 1031?
  - Recognized as intangible personal property for capitalization rules
    - Treas. Reg. § 1.263(a)-4(c)(1)(vi), -4(d)(3)
  - Comes within definition of real property
    - I.R.C. § 897(c)(6); Treas. Reg. § 1.1250-1(e)(3)(i); Treas. Reg. § 1.263A-8(c)(1)
  - Treated as real property for like-kind requirement
- Leasehold in real property of less than 30 years
  - Probably not like kind to fee
  - Maybe like kind to other lease with similar length
    - Check definition of real property

Leasehold Improvement Situation



Objective

- Exchanger would like to use the proceeds from the sale of its property to construct improvements on the raw land
- Exchanger wants 1031 nonrecognition

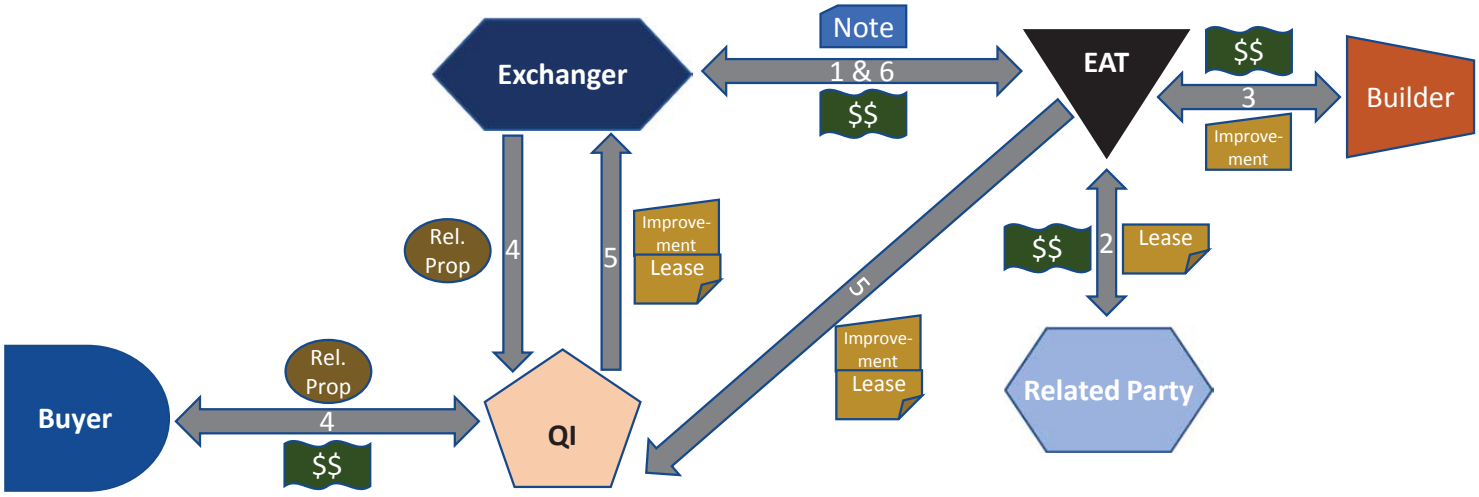
Relevant Section 1031 Elements

- Keys to improvement exchanges
  - Like Kind
  - Real Property
  - Exchange
- Related-Party Rules

Planning Strategy

- Avoid building on already-owned property
  - Use related party's property
- Avoid basis shifting and cashing out
  - Ensure that improvements, not already-owned property, are the replacement property

Leasehold Improvements Exchange



1. Exchanger lends funds to EAT.
2. Related Party grants an arms-length 32-year leasehold in raw land to EAT.
3. EAT constructs improvements on the leased raw land, and Exchanger identifies Rel. Prop. within 45 days.
4. Exchanger transfers Rel. Prop., and QI is treated as selling Rel. Prop. to Buyer, and QI receives exchange proceeds.
5. QI uses exchange proceeds to purchase improved Rep. Prop. leasehold from EAT and transfer it to Exchanger.
6. EAT pays off construction loan.

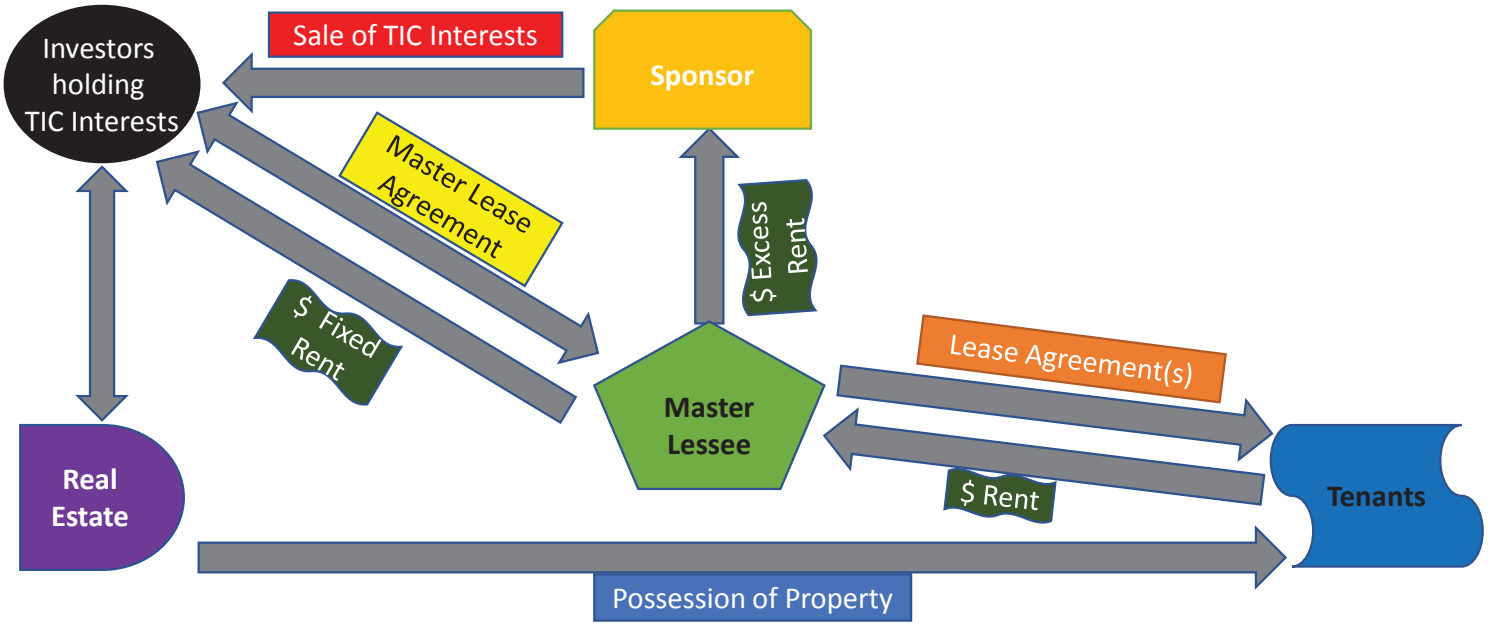
I.R.S. Approved Leasehold Improvement Exchange

- IRS approved leasehold improvement exchange in PLR 200251008
  - Unrelated party owned fee
  - Related party had a 45 year ground sublease
  - Related party subleased property for 32 years to EAT to make improvements
  - Within 180 days EAT transferred leasehold and improvements to exchanger
- IRS approved similar structure in PLR 200329021
  - Related party owned long term lease of property
  - Related party assigned the lease to the EAT to make improvements
  - EAT assigned leasehold and improvements to exchanger
  - IRS approved, but required each party to hold for two years

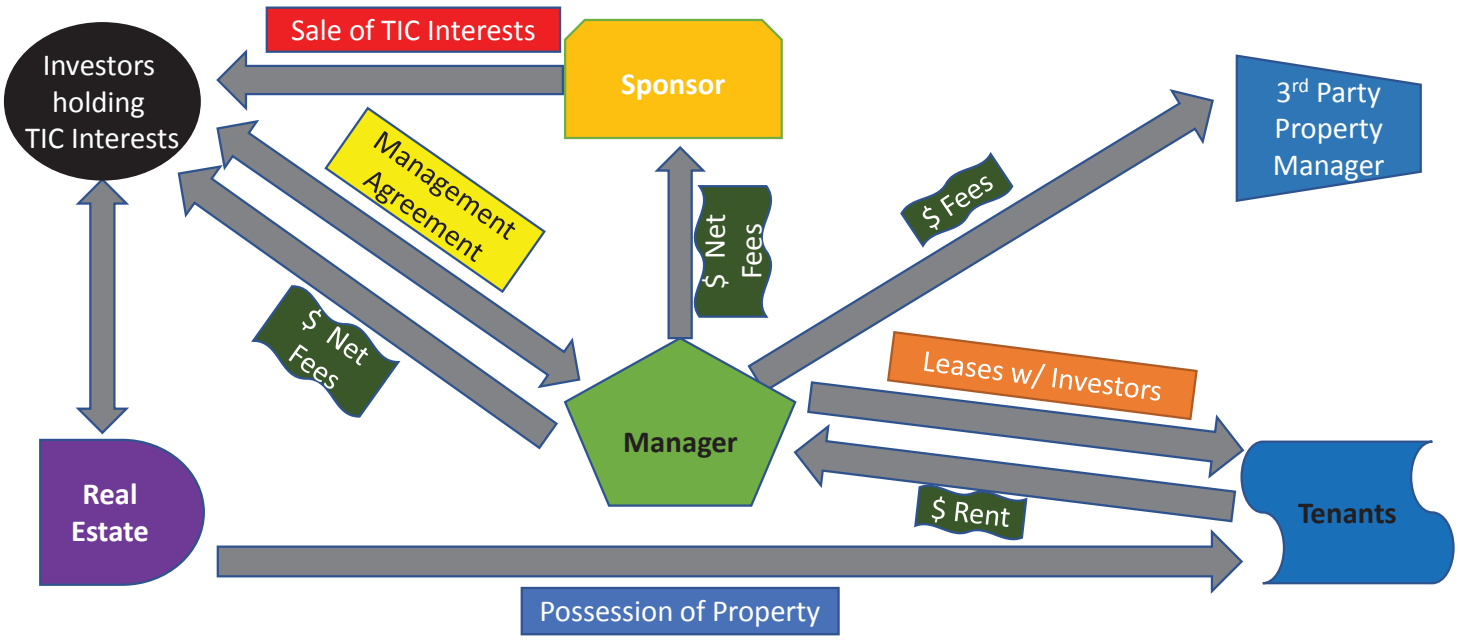
Use of Leases in TICs and DSTs

- Leases can help TICs and DSTs avoid being classified as tax partnerships

TIC Master-Lease Structure



TIC Property-Management Structure



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Professor Borden's research, scholarship, and teaching focus on taxation of real property transactions and flow-through entities (including tax partnerships, REITs, and REMICs). He teaches Federal Income Taxation, Partnership Taxation, Taxation of Real Estate Transactions, and Unincorporated Business Organizations, and he is affiliated with the Dennis J. Block Center for the Study of International Business Law. His work on flow-through and transactional tax theory appears in articles published in law reviews including Baylor Law Review, University of Cincinnati Law Review, Florida Law Review, Georgia Law Review, Houston Law Review, Iowa Law Review, Tax Lawyer, and Virginia Tax Review, among others. His articles also frequently appear in leading national tax journals including Journal of Taxation, Journal of Taxation of Investments, Real Estate Taxation, and Tax Notes.

Professor Borden is the author or co-author of several books, including Federal Income Taxation (Foundation Press, 7th ed. 2017) (with Daniel L. Simmons, Martin J. McMahon, Jr. & Dennis J. Ventry, Jr.), Federal Taxation of Corporations and Corporate Transactions (Aspen Publishers, in progress), Limited Liability Entities: a State by State Guide to LLCs, LLPs, and LPs (Wolters Kluwer Law & Business 2012, with seven annual updates), Tax-Free Like-Kind Exchanges (Civic Research Institute, 2nd ed. 2015), Taxation and Business Planning for Partnerships and LLCs (Aspen Publishers, 2017), and Taxation and Business Planning for Real Estate Taxation (LexisNexis, 2011, Carolina Academic Press, 2nd ed. 2017). The U.S. Court of Appeals for the Fifth and Ninth Circuits, the U.S. Court of Federal Claims, state judicial bodies, and federal and state bar associations have cited Professor Borden's work in their opinions and publications. He is frequently quoted in leading news publications such as The Los Angeles Times, The National Law Journal, The New York Times, and Reuters and blogs about tax issues for The Huffington Post.

Professor Borden has worked as a consultant to The Joint Committee on Taxation, Congress of the United States and often serves as an expert witness or consultant on major litigation matters that relate to real estate, flow-through taxation or legal malpractice. Before entering academia, he practiced tax law in the San Antonio, Texas law firm of Oppenheimer, Blend, Harrison & Tate, Inc. He is active in the American Bar Association Section of Taxation, is a past chair of its Sales, Exchanges & Basis Committee, and is a fellow of the American College of Tax Counsel.

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Andy Herz is a member of the American College of Real Estate Lawyers and is included in The Best Lawyers in America® and recognized as a leading lawyer in Chambers USA as a key member of our highly rated real estate department. Specifically, Chambers notes that 'the "terrific," "excellent" and "very capable" Andrew Herz has "developed a great reputation for himself" as "a seasoned real estate practitioner" in the New York market. Contemporaries state that they would refer leasing matters to him "without a shadow of a doubt."' Clients have stated that he is "an incredible leasing lawyer, probably the best in the city in terms of leasing." He has also been designated as one of only 32 real estate lawyers in the world to be included in the 2017 edition of The Best of the Best in Real Estate published by Legal Media Group. He has been an adjunct professor at both Vanderbilt Law School and Brooklyn Law School where he taught intensive commercial real estate law courses. For the past fourteen years, Mr. Herz has been a member of the Advisory Board and presenter at Georgetown University's Advanced Commercial Leasing Institute. His clients include major real estate owners and developers, hedge funds, technology providers, hospitals, professional service companies, charitable institutions and other law firms.

Andy Herz received the 2016 New York Bar Association's Real Property Law Section Professionalism Award for his "exceptional contributions of time and talent to New York real estate lawyers." The award identifies a person "possessing an outstanding level of competence, legal ability and achievement; a continuing civility and appreciation for others in his/her practice; a person who has engaged in mentoring of younger attorneys and who has been involved in Bar activities both on a state and local level."

EDUCATION

Columbia Law School (J.D., 1971)
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Articles Editor, Columbia Journal of Law and Social Problems
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Nina Kampler has more than 30 years of industry experience as a retailer, a lawyer, a broker, a restructuring advisor and a business development expert. She formed Kampler Advisory Group in 2012 to provide opportunistic value-add advisory services to the retail real estate industry.

From 2010 through 2012, she was Senior Managing Director of CBRE's Retail Services Group, managing the New York Tri-State retail brokerage platform and heading the Urban Retail Group in the Americas, integrating the high-street retail practice across the US with the practice groups in Europe.

Prior to CBRE, Ms. Kampler served as Executive Vice President for Hilco Real Estate from 2004 to 2010. She directed their strategic retail and corporate solutions group and led retail business development. Ms. Kampler collaborated with major national and international retailers and commercial companies to implement real estate portfolio restructuring strategies and includes Starbucks, Tumi, and GEOX, amongst her clients.

Previous to that, she spent 16 years at Polo Ralph Lauren Corporation, serving as their Vice President, Retail and Real Estate Counsel. In that capacity, she negotiated all store and corporate real estate transactions throughout the U.S. and Canada. She also held the position of acting General Counsel for Club Monaco.

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Danielle serves as the Chair of the Business Litigation Department. Danielle is an experienced trial attorney whose diverse practice involves all phases of litigation, from pleading through verdict and appeal. Danielle's practice includes both litigating and advising transactional clients with respect to litigation risk and litigation avoidance strategies.
Danielle has successfully handled a broad range of litigations in state and federal court as well as in arbitrations and is often retained on the eve of trial. Danielle's representations include public companies, multi-million dollar private companies, hedge funds, private equity funds, investment bankers, start-ups, developers, real estate companies, information and technology companies, high net worth individuals, and partnerships in all types of business disputes, ranging from restructuring, hotel and hospitality, real estate, and contract disputes to enforcement of restrictive covenants.

Professional Activities

American Bar Association
New York City Bar Association
Associate Member, New York City Bar Association Judiciary Committee
Member, New York State Bar Association, Committee On Women in the Law
Member, New York Supreme Court Appellate Division, First Department, Departmental Disciplinary Committee
Judicial Committee, "Program for State and Federal Judges on the Judicial Role in Selecting and Appointing of Fiduciaries, Monitors, Masters, and other Judicial Adjuncts," April 21, 2015
Chair, Women In the Law Committee, Federal Bar Association, Southern District of New York Chapter
"Pass the Torch" — Ceremony Congratulating Chief Judge Loretta Preska and Judge Colleen McMahon of the SDNY, April 20,2016
"Meet the Chiefs" — Honoring the Four Women Chief Judges of SDNY and EDNY, March 4, 2015
Federal Bar Association, Southern District of New York Chapter
Board Member, The Webster Apartments, a non-profit residence for working women and students
New York Regional Leadership Council, The One Love Foundation

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Bruce J. Leuzzi's law practice is focused on commercial real estate transactions: acquisition and sale of properties (including office buildings, loft buildings, multi-family buildings and ground leases), ground leases (representing landlords and tenants), acquisition and sale of development rights, leasing (representing landlords and tenants, including office leases, loft leases and retail leases), and financing (representing borrowers in financing and refinancing, and construction financing).

Bruce was admitted to the New York State Bar in 1989.

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Janice Mac Avoy is a member of the Real Estate Department and the Litigation Department, co-chair of the Real Estate Litigation Practice Group and co-chair of the Firm's Pro Bono Committee.

Ms. Mac Avoy concentrates her practice in complex real estate-related transactions and disputes, commercial litigation and arbitration, complex commercial landlord tenant disputes and commercial fair market rent arbitrations. She also has extensive experience in creditor's rights, including complex commercial real estate mortgage foreclosures and UCC foreclosures, workouts and restructuring of real estate secured debt. Ms. Mac Avoy works with the Firm's Real Estate Department on transactions in order to resolve issues without resorting to litigation.

Among Ms. Mac Avoy's recent noteworthy representations are:

- Normandy Real Estate Partners in its sale and acquisition of 575 Lexington Avenue.
- Richard Cohen of Capital Properties in the successful defense of a claim by a lender under a non-recourse carve-out guaranty.
- Princeton Holdings LLC in the successful arbitration of a dispute regarding the acquisition of a 50% tenant-in-common interest in the Ring Portfolio -- 14 Manhattan properties, valued in excess of US$450 million at the time of the agreement and currently worth significantly more.
- RBC in its foreclosure action and subsequent restructuring of debt on the iconic Lipstick Building in New York City.
- Lehman Brothers in connection with several foreclosure actions, including a significant development site adjacent to Hudson Yards in New York City.
- Blackstone in a potential ground lease rent reset arbitration that was successfully negotiated with the landlord without the need to resort to arbitration.

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Eric Menkes was one of the first partners in the real estate department at Duval & Stachenfeld. His primary area of expertise is commercial leasing, and he heads the firm's Leasing Practice Group. He is familiar with virtually all aspects of commercial leasing, representing landlords and tenants, in office, retail, ground lease, industrial and triple-net transactions, as well as sublease transactions. Eric has particular expertise in retail leasing, representing shopping center and street retail owners, as well as national and international retailers.

Significant retail projects include the leasing of Wynn Plaza, a luxury shopping center developed in conjunction with Crown Acquisitions adjacent to the Wynn and Encore Hotels in Las Vegas; the Showcase Mall, also in Las Vegas; the retail space at 680 Madison Avenue in New York (the former Carlton House); and 750 Seventh Avenue (the former Lehman Brothers headquarters). Current and prior retailer clients include Prada, Nike/Converse, Polo Ralph Lauren, Gucci Group; Circuit City, Kmart and H&M.

Office projects include the leasing of Industry City, a 6,000,000 square foot development in Sunset Park, Brooklyn catering largely to technology tenants, the Falchi Building and Standard Motor Products Building in Long Island City; the office buildings at 1250 Broadway, 530 Fifth Avenue and 450 West 15th Street in New York; 1801 K Street (the Federal Reserve Building) in Washington, DC and Citadel Center in Chicago. Landlord clients include RXR, Jamestown, Angelo, Gordon & Co., Belvedere Capital, Extell Realty, Olmstead Properties and Savanna.

He recently represented Boies Schiller in its headquarters lease at Hudson Yards in New York and has negotiated co-working leases on behalf of WeWork.
Mr. Menkes regularly lectures at International Council of Shopping Center law conferences; he is a contributor to The Practical Real Estate Lawyer; and he has spoken before the Real Property Law Section of the New York State Bar Association. He is former counsel and Chairman of the Board and Counsel for Miracle House of New York, a not-for-profit housing agency.

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Hope K. Plasha has a broad-based real estate practice that includes the representation of landlords and tenants in leasing transactions, owners and developers in the acquisition and construction of commercial and residential properties, investors in the structuring of joint ventures, and lenders and borrowers in a wide-spectrum of real estate financings.

Ms. Plasha serves as primary outside real estate counsel for a global media company in many of its domestic and international property matters. Representative projects include negotiating and restructuring its New York, London, and Hong Kong headquarters leases as well as numerous office and warehouse leases throughout the United States and in 37 different countries (including leases in Beijing, Tokyo, Frankfurt, Brussels, Moscow, Sao Paulo, Mumbai, Johannesburg, and many other locations), assisting in the acquisition and disposition of more than two dozen industrial and warehouse facilities (many with complex environmental issues), negotiating construction and design contracts, drafting easements/right-of-way agreements and addressing land development concerns with government agencies and utility providers, negotiating brokerage, service, and property management contracts with outside vendors, and offering general advice on real estate issues arising in the context of its corporate property portfolio (including with respect to domestic and international M&A).

EDUCATION

Yale Law School (J.D., 1996)
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Keith E. Reich has been practicing law for more than 30 years and concentrates his practice in the area of real estate law. He has wide-ranging experience with commercial leasing, lease and loan restructuring, sales and acquisitions of commercial, industrial and residential properties, ground and net leasing and green building and sustainable development. He also represents lenders and borrowers in mortgage financing and negotiates brokerage, construction and other forms of real estate agreements.

Concentrations

Commercial leasing, representing both landlords and tenants
Sales and acquisitions of commercial, industrial and residential properties
Mortgage financing, representing both lenders and borrowers
Ground and net leasing
Green building and sustainable development practice group
Real estate related bankruptcy matters
Lease and loan restructuring
Negotiation of brokerage, construction and other forms of real estate agreements

Education

- J.D., Boston University School of Law, 1981
- A.B., magna cum laude, Brown University, 1978
- with honors

Admissions

- New York