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Letters of Credit – An Increasingly Popular Tool?

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Given the general economic uncertainty in today's world and the recent market turmoil, we have seen private equity funds jostling to preserve and ensure future liquidity, albeit at a higher price than before. Similarly, in this volatile economic environment, parties to business transactions increasingly want more certainty that they will be paid. Letters of Credit ("LCs"), which are often included in revolving subscription credit facilities, provide borrowers with the ability to guarantee contracts with third parties, providing certainty to the beneficiary that they will be made whole.

In light of the above, we thought it would be helpful to set out an introduction of LCs themselves, including what they are and how they fit into revolving subscription credit facilities.

What is an LC?

For anyone unfamiliar with LCs, an LC is essentially an irrevocable undertaking for the payment of money, issued by a bank at the request of the borrower in favor of a third-party beneficiary. There are many types of LCs; however, standby LCs are most commonly found in financing transactions and seen in revolving subscription credit facilities.

Standby LCs were developed to allow banks to provide the functional equivalent of guarantees without violating regulatory restrictions prohibiting banks from issuing guarantees. A standby LC is only drawn on by the beneficiary if the borrower defaults on its obligations to the beneficiary; in this sense, it is more like a cash guarantee of specified obligations of the borrower, rather than a means of payment of those obligations.

With a standby LC, the borrower can obtain LCs from its lender as a utilization of an existing LC sub-facility that is part of a larger revolving credit loan, therefore avoiding the need to acquire a "new" loan or a guaranty. By agreeing on LC terms at the date of origination of the larger loan, the borrower has established a negotiation instrument for future business with third parties.

How do LCs fit into a Revolving Subscription Credit Facility?

Request for LC

An LC is usually governed by the terms of the loan agreement. In terms of process, the borrower simply submits an LC request to the administrative agent (within the relevant timeframes required under the loan documents), who then notifies the lender(s) of such LC request. The LC request is usually in a previously agreed-upon form that comprises part of the loan documents.

In the LC request, the borrower attaches a completed Application and Agreement for an LC and requests that the LC issuer issue an LC substantially in the form attached to the request.

The borrower also typically brings down the representations and warranties set out in the related loan documents, confirms that no event of default has occurred, and confirms that upon issuance of the related LC, the LC liability won't exceed the lesser of (1) the available commitment minus all outstanding obligations at that date and (2) the letter of credit sublimit on such date. The LC sublimit is typically between 20% to 50% of the aggregate available commitment, which amount is negotiable. An updated borrowing base is also included in the LC request.

An LC's expiration date is usually 12 months after the date of issuance, which period can be renewed at the discretion of the LC issuer. LCs that expire beyond maturity will need to be cash collateralized in full (usually 30 days prior to maturity). Many subscription line lenders will require LCs to be cash collateralized with the proceeds of capital calls only to avoid bankruptcy preference risk. Issues relating to cash collateralizing LCs were recently discussed **here**.

Functionality

LCs that are outstanding and have not been drawn by their beneficiaries reduce the available commitment under the loan agreement because they must be funded by the lenders if they are drawn by their beneficiaries. This is the case regardless of whether the borrower could, at that time, satisfy the conditions precedent in the related loan agreement and borrow new loans under the related credit facility.

In the event of any drawing under an LC, the borrower is required to reimburse the LC issuer for the amount of such drawing together with interest, expenses and fees incurred by the LC issuer in connection with such payment. The borrower can make such reimbursement with either the proceeds of a loan from the underlying credit facility or with funds from other sources. When the underlying loan is syndicated, the lenders usually participate in the LC on a *pro rata* basis; however, sometimes only certain of the lenders agree at the outset to participate in any LCs.

Collateral and Liability

LCs share equally in the collateral and guarantees that support the loans made under the related credit facility. The LC issuer typically has no liability (absent fraud or gross negligence) for any action taken with respect to each LC. The borrower assumes all risk of the acts or omissions of any beneficiary with respect to its use of any LC.

Termination

If the obligations under the loan agreement become payable prior to the maturity date, the administrative agent can declare the obligation of the LC issuer to issue LCs under the loan agreement terminated or declare the LC liability to be due and payable, and demand that the borrowers cash collateralize, as security for the obligations, an amount equal to the LC liability plus any required reserves (for example, reserves for currency fluctuations) at the time such notice is given.

The cash collateral account is included in the collateral package granted by the borrowers to the administrative agent for the benefit of the secured parties. After all LCs have expired or been fully drawn upon, all LC liability has been satisfied and all other obligations have been paid in full, the balance, if any, of cash collateral held in a cash collateral account is required to be returned to the borrowers.