Letters of Credit: Financing Considerations and Terms for Negotiation

Jun 05, 2026

Categories:

Publications
The Carveout

Authors:

Maya P. Prentice
Joshua (Josh) D. Brock
Colin C. Stouffer
W. Andrew Teague

In a time where the financial markets seem to shift with each breaking headline, understanding the benefits that letters of credit can provide to borrowers and lenders in commercial real estate financing transactions becomes increasingly important. For borrowers concerned with depleting cash reserves, particularly for loans where security deposits or escrow requirements may already be significant, letters of credit provide an opportunity to reallocate the available cash risk to a trustworthy third party. This reallocation of risks gives lenders assurance that the return on their investment is secure with a reliable counterpart and is separate from the risk of the underlying loan and any related defaults.

This article examines the fundamentals of letters of credit and the key terms that borrowers and lenders should consider addressing when using letters of credit in financing transactions.

Understanding the Basics

A letter of credit is a bank's independent promise to pay a beneficiary a predetermined sum of money upon presentation of the applicable letter of credit documents, regardless of what may be happening between counterparties in the larger transaction underlying the need for the letter of credit. For every letter of credit, there are three parties involved: (1) the applicant, (2) the issuing bank, and (3) the beneficiary. The applicant for a letter of credit is typically involved in the underlying commercial transaction the letter of credit will serve to support, and the applicant will be responsible for paying any fees to the issuing bank and reimbursing the issuing bank for any draws on the letter of credit by the beneficiary.

Once a letter of credit application is accepted by the issuing bank, the issuing bank is then responsible for issuing the agreed letter of credit to the beneficiary listed on the application. The beneficiary,

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

who is also typically party to the underlying transaction, will have the right to then draw on the letter of credit so long as the beneficiary satisfies any applicable draw conditions, as we discuss further below. Since the primary focus of this article is on letters of credit in commercial real estate finance transactions, we will refer to the applicant as the "Borrower" and the beneficiary as the "Lender."

One element that makes letters of credit attractive to Lenders, particularly when they are negotiating financing terms with a Borrower with liquidity concerns, is the "independence principle" fundamental to letters of credit. Under this principle, the issuing bank must honor the letter of credit regardless of the status of the underlying obligation—allowing the Lender to rely on the issuing bank's creditworthiness rather than the Borrower's.

The independence principle is further supported by the fact that letters of credit are generally irrevocable by the issuing bank before their stated expiration date, again isolating the issuing bank from the term of the underlying transaction or any increase in risk on the part of the Borrower. Given the independence of the issuing bank from the underlying transaction, this makes letters of credit distinct from commercial guarantees and sureties, which are often issued by affiliates of the Borrower, and it also means there are distinct considerations for the terms that will be negotiated for a letter of credit.

Default Terms

For letters of credit governed by the law of any state in the U.S., Article 5 of the Uniform Commercial Code (UCC) will apply. Like many other UCC provisions, a revised version of Article 5 has been adopted in New York, but other states generally follow Article 5 as proposed by the Uniform Law Commission and American Law Institute. Beyond the UCC, a letter of credit may also incorporate by reference a set of industry rules in place of, or in addition to, the laws of a particular state.

Under Article 5 of the UCC, the duration and transferability of a letter of credit are two of the most important default terms to be

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

aware of and understand. Standby letters of credit, which are the most common type of letter of credit in a financing transaction, have a default term of one year under the UCC, and to the extent that a letter of credit states that it is perpetual, it will have a term of five years. Regarding transferability of a letter of credit, the default under the UCC is to restrict the right of the Lender to transfer the letter of credit, meaning that the Lender may not transfer its right to draw under the letter of credit to another party unless the letter of credit expressly states that it is transferable.

That said, even if a letter of credit is silent on transferability, the default terms under the UCC permit the Lender to assign its right to receive proceeds of a draw to a third party, but in order to perfect the interest of such third party, the issuing bank must expressly consent to such assignment. This assignment does not transfer the right to present documents or demand payment, and the original Lender will remain the party entitled to draw on the credit, but a third party could have a recognizable right to the proceeds coming from the draw as long as the issuing bank consents to the assignment and the letter of credit does not expressly prohibit such an assignment.

If a Lender or Borrower is interested in extending the term of a letter of credit to align with the term of the underlying transaction, to allow for transferability of the letter of credit, or prohibit an assignment of proceeds, legal teams should be prepared to negotiate a departure from the default terms under the UCC and industry rules.

Negotiating for Borrower and Lender Considerations

Below is a brief discussion of some of the most commonly negotiated letter of credit terms, including a deeper discussion of the duration and transferability concepts introduced above.

- **Duration:** To avoid the default one-year duration imposed by the UCC, many Lenders will incorporate an automatic renewal clause that will cause the letter of credit to automatically

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

renew at the expiration of each one-year term, unless a notice of non-renewal is provided. In addition to automatic renewals, Lenders will often include terms that expressly permit them to draw on the letter of credit upon a notice of non-renewal where there has not been a replacement letter of credit issued.

- **Transferability:** To avoid the default imposed by the UCC restricting Lenders from assigning their rights under a letter of credit, Lenders will typically require that a letter of credit expressly stipulate that they can freely transfer such letter of credit, that the issuing bank's consent is not required to authorize the transfer, and that the costs of any transfer be the responsibility of the Borrower.
- **Issuing bank:** Given that letters of credit are often turned to in order to reallocate a liquidity risk of a Borrower, the loan agreement governing the larger transaction will include specific requirements for the eligibility of the issuing bank. These conditions may include specifying a certain bank to serve as the issuing bank or simply including rating agencies requirements for any bank that will serve as the issuing bank.
- **Partial draws:** Where a letter of credit serves as a backup guarantee for a Borrower's obligations, Borrowers and Lenders may have an interest in providing that the Lender may partially draw on the letter of credit, as opposed to a requirement that a draw be for the full amount of the letter of credit.
- **Draw conditions:** With respect to the conditions that must be met for the issuing bank to issue proceeds of the letter of credit to the Lender, Lenders most often stipulate that letters of credit are drawable solely based on a statement from a Lender that a draw is permitted. On the other hand, Borrowers have an interest in outlining the events that give Lenders the right to draw on the letter of credit. Most commonly, it is negotiated whether the Lender can draw when: (1) the Lender receives a non-renewal notice of the letter of credit; (2) the Lender receives a termination notice for the underlying obligation or notice of an event of default on the underlying

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

obligation; (3) the term of the underlying obligation is set to expire; (4) the issuing bank ceases to be a bank approved by the applicable Lender; (5) the issuing bank fails to issue a replacement for a lost, mutilated, stolen, or destroyed letter of credit; or (6) the issuing bank fails to consent to a transfer by the applicable Lender.

- **Presentment and payment timing:** To ensure administrative convenience and certainty of receipt and to minimize any timing risk, Lenders may negotiate to provide the specific location for presentment, often requiring presentment at a specific branch or by electronic means. They may also require that the letter of credit provide for prompt payment once the draw conditions have been met. The issuing bank, by contrast, may seek to allow reasonable processing time following a draw on the letter of credit and flexibility in presentment mechanics, including standard business hours and cut-off times to align with the issuing bank's operational practices.

Taking the Advantage

Letters of credit provide a unique opportunity for Lenders to substitute a reliance on a Borrower's credibility with a reliance on an issuing bank's credibility. Further, letters of credit allow Borrowers to soften the risk of unfortunate timing demands when a Lender draws on the letter of credit because the obligation to provide immediate funds is with the issuing bank instead of the Borrower. Given the unique advantages these instruments can provide in commercial real estate financing transactions, it is important to be aware of the terms that will be crucial to negotiate for in order to leverage those advantages and maintain each of the Lender's and the Borrower's security in the underlying transaction.

FBT Gibbons has a long history of representing and collaborating with institutional, community and regional banks, as well as a variety of commercial borrowers. We are here to help evaluate when a letter of credit may make sense in a larger financing transaction, and, when needed, we are equipped to advise on the terms that make sense for you. For more information or assistance, contact the authors or any attorneys with the firm's Commercial Real Estate

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

Finance team.

The Carveout

A legal blog geared toward sophisticated capital market participants, The Carveout provides insight into current trends and developments in commercial real estate finance (CREF)—with a particular focus on non-recourse carveouts and CREF loan platforms including CMBS, debt funds, private capital, REITs, life insurance companies, and other complex sources of capital.

Visit Blog

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons