Letter of Credit Migration

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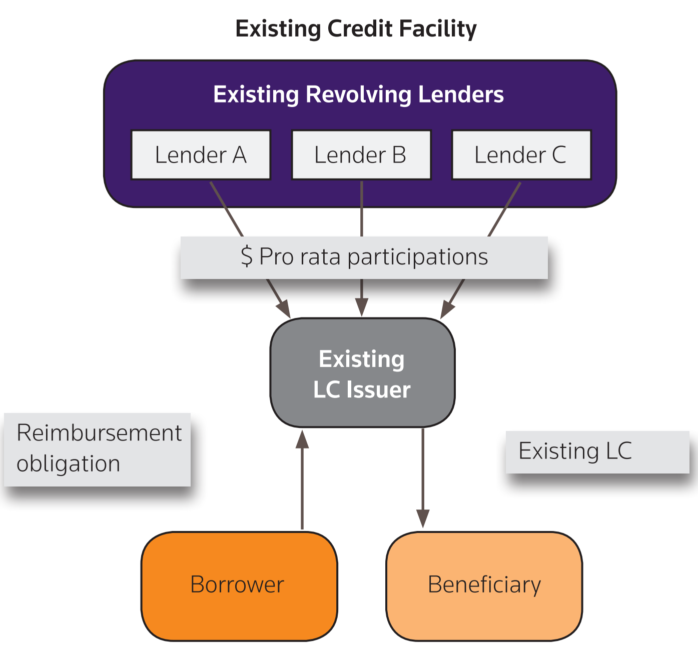
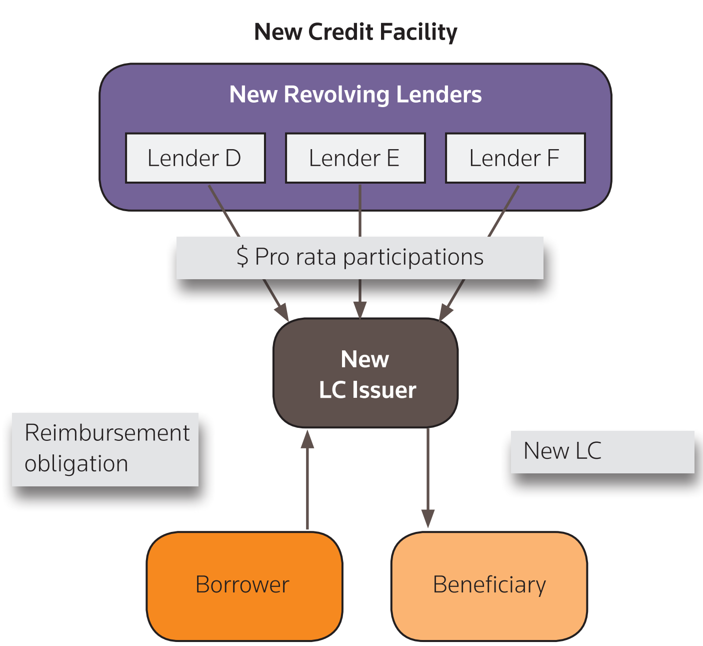
This Note discusses letter of credit migration issues and common situations where letter of credit migration is required and presents three techniques for implementing letter of credit migrations.

Letter of credit migration refers to the situation where existing letters of credit, which were issued under either a credit facility or a standalone letter of credit arrangement, are transferred to a new credit facility. After the letters of credit are transferred or migrated to the new facility, the new facility's terms apply to the applicant's reimbursement and other obligations under those letters of credit in favor of the issuing bank. For more information on letters of credit in financing transactions, see *Practice Note, Letters of Credit in Financing Transactions: Overview (http://us.practicallaw.com/1-505-9216)*.

A common scenario involving letter of credit migration, depicted in the diagrams below, entails a borrower refinancing an existing credit facility that has a letter of credit subfacility where a number of existing letters of credit are outstanding. (This scenario can also arise in the context of an acquisition, where the acquisition financing replaces the target company's pre-existing credit facility.) The borrower's new credit facility includes a new letter of credit subfacility. It is contemplated that the beneficiaries of the existing letters of credit will receive replacement letters of credit issued under the new facility's letter of credit subfacility.

This Note lays out the different options for letter of credit migration using this typical example. However, the tools and methods presented here can be used in other scenarios, such as rolling up existing bilateral letter of credit arrangements (which provide for the issuance of letters of credit based on cash collateral or other credit support given directly to the letter of credit issuer, rather than as part of a syndicated loan facility) into a new credit facility.





PROBLEMS ENCOUNTERED WITH LETTER OF CREDIT MIGRATION

In many instances where letters of credit are migrated to a new credit facility, a problem arises as a result of the need to simultaneously satisfy the following three constraints:

- The beneficiaries of the existing letters of credit will not return the letters of credit to the issuing bank for cancellation until they receive replacement letters of credit, because they want to avoid any gap in coverage.
- The issuing bank of the existing letters of credit requires credit support for maintaining them until the letters of credit are returned by the beneficiaries for cancellation.
- The lenders and other secured parties under the new credit facility (including the issuing bank of the new letters of credit) do not want the issuing bank of the existing letters of credit to retain a lien over the borrower's assets or any other form of credit support. This would dilute the collateral package or other credit support that the borrower must provide to support its obligations under the new credit facility. (The dilution would last until the existing letters of credit are returned by the beneficiaries for cancellation.)

The simplest way to satisfy all three constraints is for the following steps to occur simultaneously at the closing of the new credit facility:

- The new letters of credit are issued and delivered to the beneficiaries.
- The existing letters of credit are returned to the issuing bank for cancellation.
- All credit support in favor of the issuing bank of the existing letters of credit is released and terminated.

In reality, it often takes a few days to arrange for the issuance of the new letters of credit and the return and cancellation of the existing letters of credit. This creates a timing problem, and makes it impossible to satisfy the three constraints concurrently. The different techniques for letter of credit migration are attempts to bridge this timing gap.

ROLLOVER OF EXISTING LETTERS OF CREDIT

The simplest method of migrating letters of credit is to roll them over to the new credit facility.

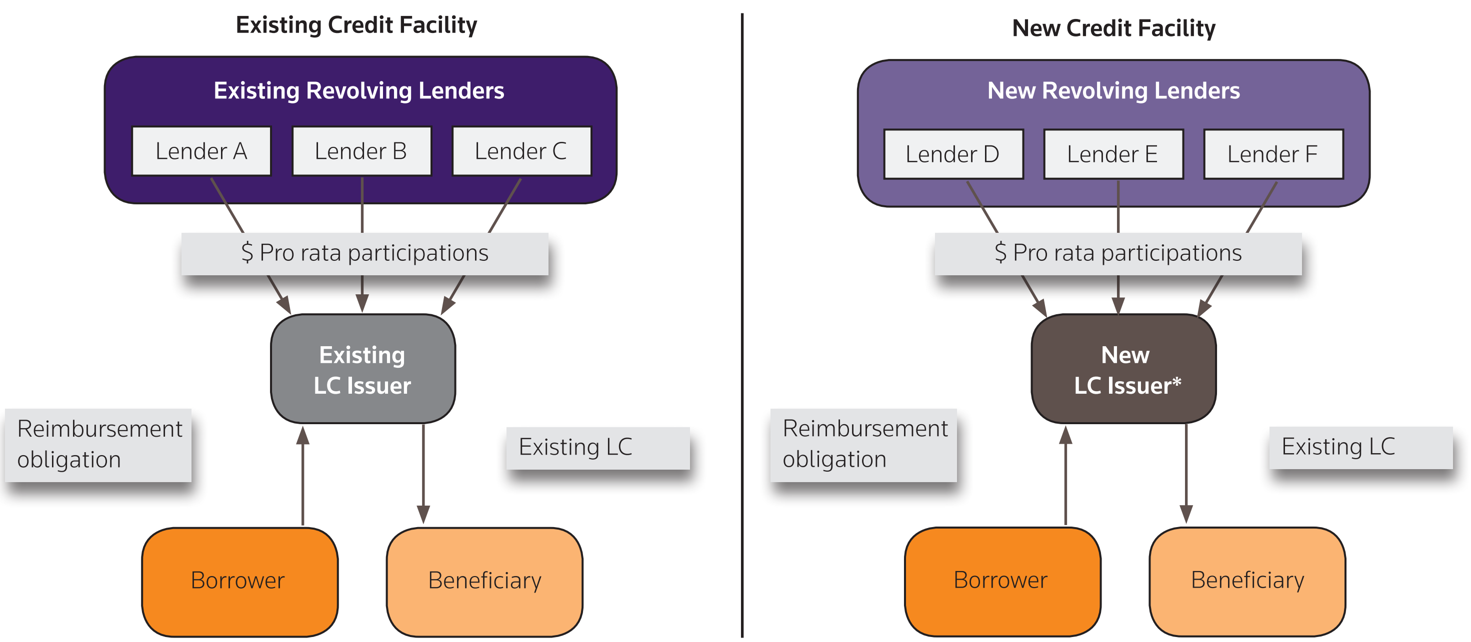
HOW A ROLLOVER WORKS

It is possible to roll over the existing letters of credit into the new credit facility when the issuer (or each of the issuers, if more than one) of the existing letters of credit is the same financial institution (or is one of the set of financial institutions) that issues letters of credit under the new facility's letter of credit subfacility. In this scenario, the beneficiaries under the existing letters of credit do not have to return their letters of credit because the existing letters of credit will remain outstanding. The credit agreement for the new facility should acknowledge that the existing letters of credit will be treated as though they were issued under the new facility from the beginning. Accordingly, the issuer benefits from the credit support of the new facility and does not need to maintain any claims under the existing facility. Therefore, the existing facility can be terminated and the liens securing it can be released. There is no need for any special documentation or carveouts to effect the rollover because it is expressly provided under the new facility that the existing letters of credit are rolled over as new letters of credit.

In the meantime, the parties should confirm that the issuer is comfortable continuing to use the same letter of credit documentation that it used before the rollover, at least until the scheduled expiration of the existing letters of credit and their replacement by letters of credit issued under the new facility. Problems can arise if:

- The letter of credit documentation for the existing letters of credit conflicts with the letter of credit mechanics under the new credit facility.
- The issuing bank insists on changing its letter of credit documentation by reference to an updated institutional form.

Solution 1: Pure Rollover



*Same institution as Existing LC Issuer

ADVANTAGES AND DISADVANTAGES OF ROLLOVERS

The chief advantage of a pure rollover of the existing letters of credit, if available, is that it is the least expensive and simplest method of handling letter of credit migration:

- There is no need for the borrower to provide "cover" to the issuer in the form of cash collateral or a backstop letter of credit.
- There is no need for the borrower to make arrangements with the beneficiaries for the replacement and return of the existing letters of credit - the beneficiaries can keep those letters of credit until the scheduled expiration dates.

When the existing letters of credit expire, they are replaced (if needed) by new letters of credit issued under the new credit facility.

Generally, a pure rollover is unavailable when the designated letter of credit issuer under the new credit facility is not the same institution as the issuer of the existing letters of credit under the existing facility. Sometimes, if the new facility is structured to allow for more than one letter of credit issuer, a pure rollover can be effected even if the issuer of the existing letters of credit is not contemplated to be an issuer of letters of credit under the new credit facility throughout its term. This is done by permitting the issuer of the existing letters of credit to be an additional issuing bank under the new credit facility temporarily, until the existing letters of credit expire.

CASH COLLATERALIZATION OF EXISTING LETTERS OF CREDIT

A second approach to letter of credit migration involves cash collateralizing the existing letters of credit.

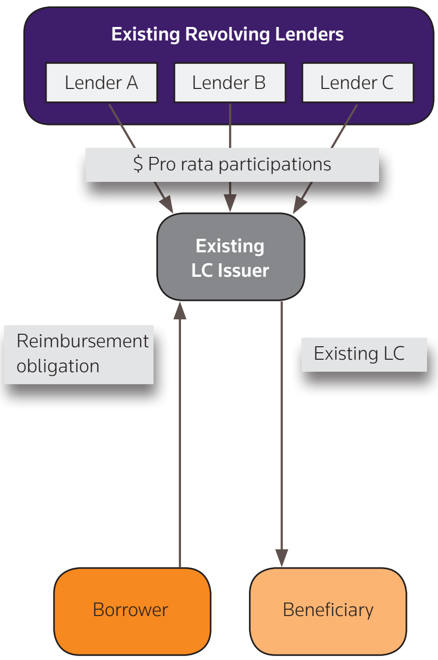
HOW CASH COLLATERALIZATION WORKS

Normally, where the borrower cash collateralizes the existing letters of credit:

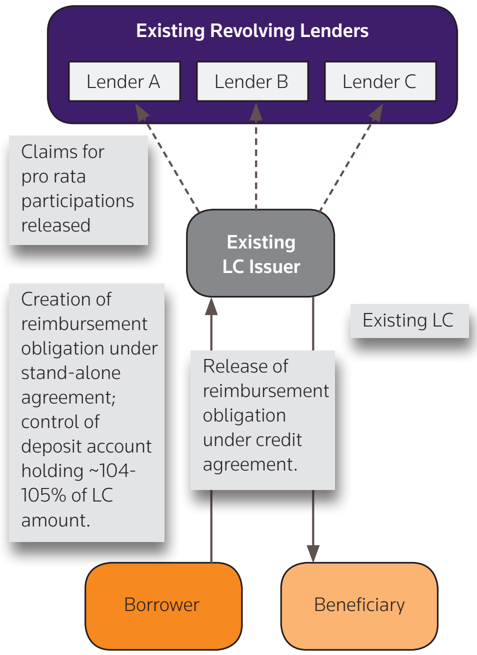
- The borrower sets up a deposit account, and transfers an appropriate amount of funds into the deposit account. In many cases, the borrower must provide cash collateral in an amount equal to 104% or 105% of the face amount of the existing letters of credit. This covers the amount of any draws and letter of credit fronting fees and other associated costs.
- The borrower pledges the deposit account to the issuing bank of the existing letters of credit to secure the borrower's obligations in respect of the existing letters of credit – this establishes the cash collateralization of the existing letters of credit.
- Once the existing letters of credit are cash collateralized, the issuer can release its claims under the existing credit facility against the borrower, and against the revolving lenders, which would otherwise be liable for their participations in the outstanding letters of credit.
- The remaining obligations of the borrower under the existing facility can then be paid off. The existing facility is terminated and the liens securing it are released.
- A new agreement, often known as a "continuing letter of credit agreement," is entered into between the borrower and the issuer of the existing letters of credit. The continuing letter of credit agreement contains those applicable provisions for the existing letters of credit that were contained in the now-terminated original loan agreement (see *Box, Continuing Letter of Credit Agreement*). For example, the continuing letter of credit agreement includes provisions governing the borrower's reimbursement obligation for the existing letters of credit, and terms relating to ongoing fees for the letters of credit. Customarily, the continuing letter of credit agreement is based on a form provided by the issuer (note that when the agent acts as an issuer, as is common, the form comes from the agent's letter of credit desk, which may involve different personnel than the negotiation and syndication teams). However, the borrower may want to conform the economic terms (such as terms relating to fees) to those that were contained in the original credit agreement or negotiate new, improved terms based upon the cash collateral security being provided by the borrower.
- The issuer of the existing letters of credit looks to the cash collateral to support the borrower's obligations under the existing letters of credit until the beneficiaries receive replacement letters of credit under the new credit facility and return the existing letters of credit to the issuer for cancellation.
- As soon as practicable after the closing of the new credit facility, new letters of credit are issued in favor of the beneficiaries of the existing letters of credit.
- Once the beneficiaries receive their new letters of credit, they return the existing letters of credit to the borrower, which are then sent to the issuer for cancellation.
- Once the existing letters of credit are cancelled:
  - the lien on the cash collateral is terminated and the cash is released from the deposit account and returned to the borrower; and
  - by its terms, the continuing letter of credit agreement terminates.

Solution 2: Cash Collateralization

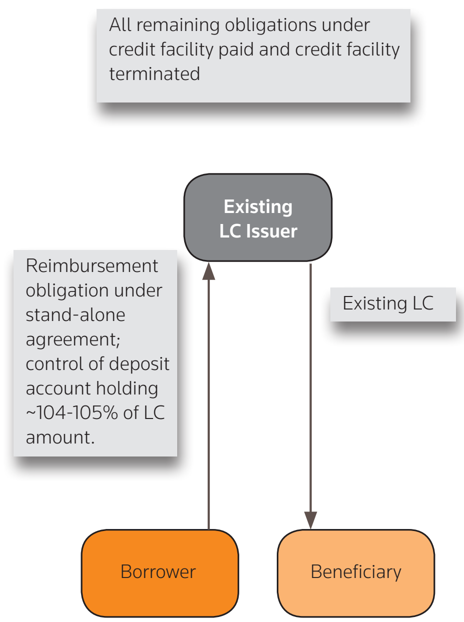
Existing Credit Facility



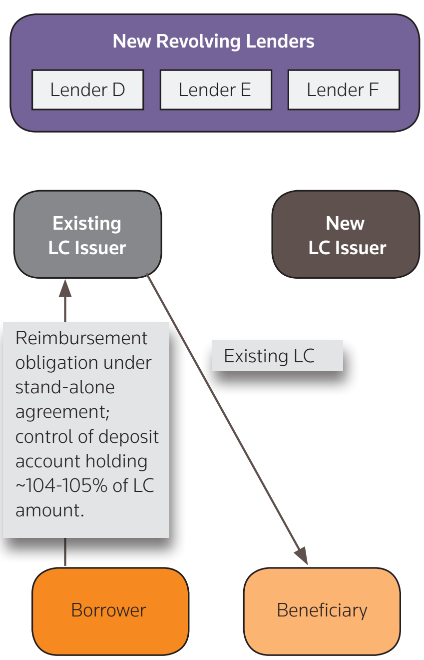
Step 1: Cash Collateral



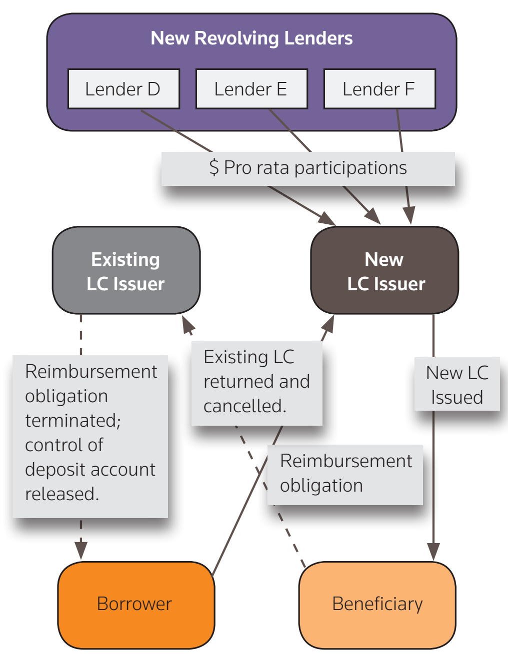
Step 2: Existing Facility Payoff



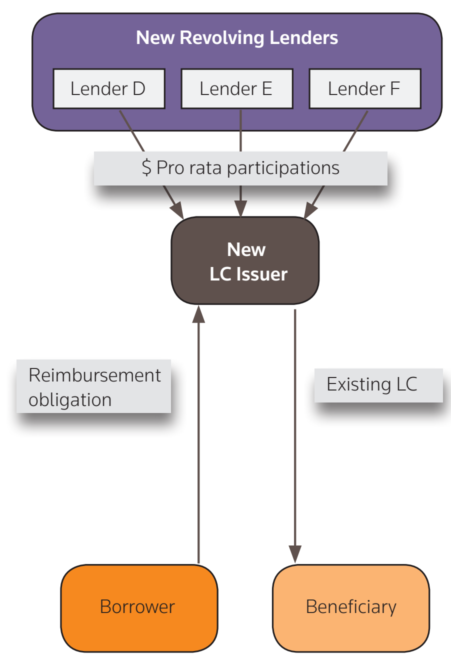
Step 3: New Facility Established



Step 4: New LC Issued



Final State: New Credit Facility



Under some circumstances, the borrower may prefer to maintain the existing letters of credit outstanding (under the continuing letter of credit agreement, using the cash collateral for credit support) until their scheduled expiration, rather than replace them sooner with letters of credit issued under the new credit facility. These circumstances may arise when the terms of the existing letters of credit are particularly favorable, or when there are unusual administrative obstacles to having the beneficiary agree to accept a replacement letter of credit prior to expiration of the existing one. In those cases, Step 4 in the diagram above would not occur unless the existing letter of credit needed to be replaced upon expiration (for example, in "evergreen" letter of credit arrangements); if such a replacement is necessary, Step 4 would occur upon the scheduled expiration of the existing letter of credit.

ADVANTAGES AND DISADVANTAGES OF CASH COLLATERALIZATION

The principal advantage of cash collateralizing the existing letters of credit is its simplicity. Cash collateralization handles the transition of existing letters of credit to new letters of credit with little additional documentation. In most cases, cash collateralization can be effected with:

- Minor changes to the payoff letter for the existing facility (see *Standard Documents, Payoff Letter (http://us.practicallaw.com/2-381-2934)*).
- A continuing letter of credit agreement providing for the terms of the existing letters of credit until they are cancelled.
- A short-form security agreement pledging the cash collateral account to the issuer of the existing letters of credit. (Alternatively, this can be built into the continuing letter of credit agreement.)

However, the disadvantage of the cash collateralization approach is its expense. Providing cash collateral for the existing letters of credit can be an expensive method of bridging the gap. Typically, the borrower must pay:

- Letter of credit fees for the existing letters of credit and the new letters of credit until the existing letters of credit are returned and cancelled.
- The full interest rate (for example LIBOR plus an interest rate spread) on any cash that the borrower must borrow to fund the deposit to the cash collateral account, offset by any interest that the borrower may earn on the deposit; if any interest is earned, it is typically much lower than the interest paid, resulting in significant "negative carry."

BACK-TO-BACK LETTERS OF CREDIT

Another approach to migrating letters of credit involves temporary letters of credit being issued under the new credit facility to provide credit support for the issuer of the existing letters of credit. These temporary letters of credit are often called backstop letters of credit and the arrangement in which the backstop letters of credit are used to support the existing letters of credit is referred to as "back-to-back letters of credit."

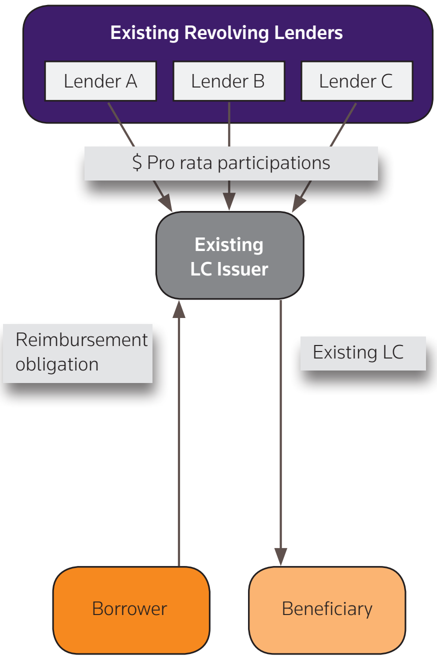
HOW BACK-TO-BACK LETTERS OF CREDIT WORK

If back-to-back letters of credit are used to migrate existing letters of credit:

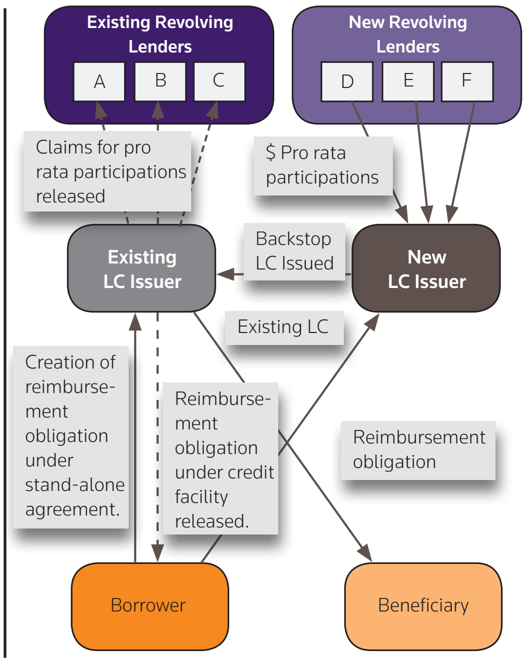
- The borrower arranges for backstop letters of credit to be issued under the new facility immediately upon closing. The issuer of the existing letters of credit is named as the beneficiary of the backstop letters of credit.
- The issuer of the existing letters of credit then releases its claims under the existing facility. The existing facility is terminated and the liens securing it are released.
- A continuing letter of credit agreement is entered into between the issuer of the existing letters of credit and the borrower, which includes those provisions in the now-terminated existing credit facility agreement that apply to the existing letters of credit (see *Box, Continuing Letter of Credit Agreement*).
- Simultaneously with the issuance of the backstop letters of credit, new letters of credit are also issued in favor of the beneficiaries of the existing letters of credit.
- Once the beneficiaries receive their new letters of credit, they return the existing letters of credit to the borrower, which are then sent to the issuer for cancellation.
- Once the existing letters of credit are cancelled:
  - the issuer of the existing letters of credit returns the backstop letters of credit for cancellation; and
  - by its terms, the continuing letter of credit agreement terminates.

Solution 3: Back-to-back LCs

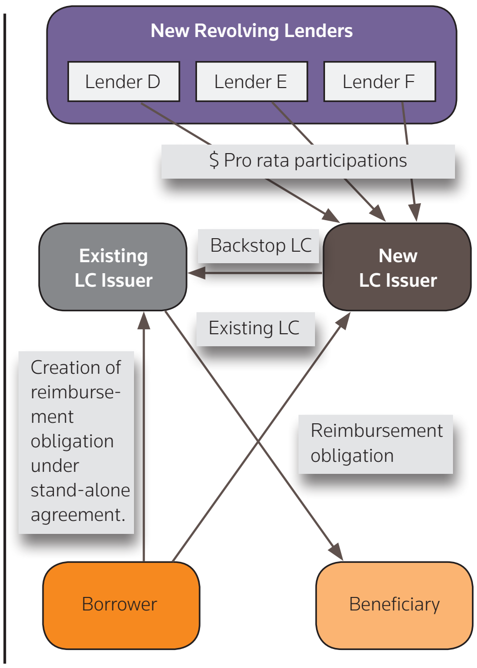
Existing Credit Facility



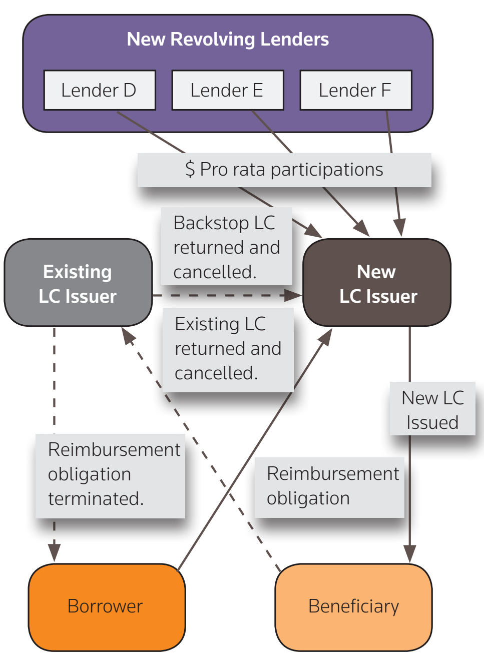
Step 1: New Facility Established, Backstop LC Issued



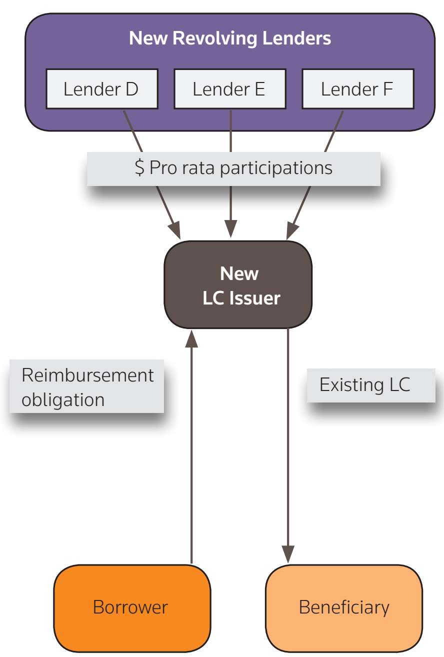
Step 2: Existing Facility Payoff



Step 3: New LC Issued



Final State: New Credit Facility



As in the cash collateralization scenario, under some circumstances the borrower may prefer to maintain the existing letters of credit outstanding (under the continuing letter of credit agreement, using the backstop letters of credit for credit support) until their scheduled expiration, rather than replace them sooner with letters of credit issued under the new credit facility. In those cases, Step 3 in the diagram above would not occur unless the existing letter of credit needed to be replaced upon expiration (for example, in "evergreen" letter of credit arrangements); if such a replacement is necessary, Step 3 would occur upon the scheduled expiration of the existing letter of credit.

ADVANTAGES AND DISADVANTAGES OF BACK-TO-BACK LETTERS OF CREDIT

The advantage of using back-to-back letters of credit instead of cash collateralization is that back-to-back letters of credit often cost the borrower less.

As with cash collateralization, the borrower must pay letter of credit fees for both the existing letters of credit and the new letters of credit until the existing letters of credit are returned to the issuer and cancelled. However, the cost of credit support provided by the backstop letters of credit is generally lower than that provided by cash collateral deposits. If back-to-back letters of credit are used, the borrower must pay fees on the backstop letters of credit. Conventionally, these fees are equal to the interest rate spread applicable to loans under the credit facility. If instead, the borrower borrows funds so that it can cash collateralize the existing letters of credit, the borrower must pay the full interest rate on those borrowed funds (generally, LIBOR plus the spread), offset by any interest that the borrower may earn on the deposit. Thus, in the cash collateralization scenario (as compared to the back-to-back letter of credit scenario), the borrower will pay additional costs equal to LIBOR, less interest earned, until the existing letters of credit are returned and the backstop letter of credit can be terminated.

Two practical disadvantages arise from the use of back-to-back letters of credit, which are that:

- The issuer of the existing letters of credit must receive the new backstop letters of credit, and confirm the release of its claims under the existing credit facility, on the closing date of the new credit facility.
- The letter of credit facility under the new credit agreement must have a subfacility limit that is high enough to accommodate both the new letters of credit and the backstop letters of credit – this is because, for a while, both the new and backstop letters of credit will be outstanding under the new credit facility.

PRACTICAL ISSUES WHEN USING CASH COLLATERAL OR BACK-TO-BACK LETTERS OF CREDIT

Several practical issues arise in letter of credit migrations that are common to both the cash collateral and back-to-back letter of credit approaches. If the borrower uses either method to migrate letters of credit from an existing credit facility to a new facility, the borrower should:

- Contact the beneficiaries of the existing letters of credit well in advance of the closing date of the new credit facility to ensure that the new letters of credit are in an acceptable form. Different financial institutions use different forms of letters of credit, so the borrower should ensure that the beneficiaries will accept the new letters of credit and promptly return their existing letters of credit.
- Coordinate with the issuing bank of the new letters of credit to ensure that all of its requirements for issuing letters of credit can be satisfied as of the closing date of the new credit facility. This may require submitting letter of credit application forms to the new issuer a few days in advance of closing.
- Make sure that either:
  - the debt, lien and investment covenants in the new credit facility have dedicated carveouts to permit the existing letters of credit and any backstop letters of credit or cash collateral; or
  - the general debt, lien and investment baskets in the new credit facility are large enough to accommodate the migration arrangements until the existing letters of credit are returned to the issuing bank for cancellation.
- If the issuing bank of the existing letters of credit is a different institution from the agent under the existing facility, check that the agent will be able to release the obligations of the borrower and the other lenders under the existing facility in respect of the existing letters of credit. In these circumstances, the payoff letter for the existing facility should include a condition that the agent must receive an issuing lender release from the issuing bank. An issuing lender release is delivered to the agent and the borrower once the issuing bank has received cash collateral or backstop letters of credit for the existing letters of credit. In the release, the issuing bank states that satisfactory arrangements have been made to substitute either cash collateral or backstop letters of credit for its rights under the existing facility as the issuer of the existing letters of credit. The issuer then releases all claims it has against the agent and other lenders for the existing letters of credit under the existing credit facility.

CONTINUING LETTER OF CREDIT AGREEMENT

In situations where letter of credit migration is achieved by cash collateralizing existing letters of credit, or by using back-to-back letters of credit, a new agreement, often known as a "continuing letter of credit agreement," is entered into between the borrower and the issuer of the existing letters of credit.

The continuing letter of credit agreement contains those provisions applicable to the existing letters of credit that were contained in the now-terminated original loan agreement. For example, the continuing letter of credit agreement includes provisions that govern:

- The borrower's reimbursement obligation for the existing letters of credit.
- Ongoing fees for the letters of credit.

Typically, the continuing letter of credit agreement is based on a form provided by the issuer (note that when the agent acts as an issuer, as is common, the form comes from the agent's letter of credit desk, which may involve different personnel than the negotiation and syndication teams). The borrower may want to make sure that the economic terms in the continuing letter of credit agreement (such as terms relating to fees) conform to those that were contained in the original credit agreement or negotiate new, improved terms based upon the cash collateral or backstop letter of credit security being provided by the borrower. That way, its obligations in favor of the issuer are no more onerous than they were prior to the letter of credit migration.