

PROVIDING ASSURANCES: LETTERS OF CREDIT

A common circumstance that arises in the realm of financial assurance is where the owner of a permitted hazardous waste management facility (HWMF) must switch from the financial test to a letter of credit. This typically arises from a triggering event such as the assumption of new debt or weak financial performance in a given fiscal year. The threshold question that must be answered when such a circumstance arises is: When must the permittee establish an alternative means of demonstrating financial assurance? To answer this question, it must first be understood that compliance with the financial test is based on the parent corporation's most recent *audited annual financial report*. So, for example, if the corporate parent assumes debt for an acquisition in the middle of a fiscal year, and it is possible that this event might cause the parent corporation to fail the financial test, no immediate action is necessary.¹ With this in mind, the first important deadline comes 90 days following the end of the fiscal year. By this date, the owner of the permitted HWMF must submit a notice to the regulatory authority of its intention to switch from the financial test to a letter of credit.

Okay, so compliance with the notice requirement doesn't sound so bad. However, what must the owner of the permitted HWMF do to secure a letter of credit? And, what must the owner of the permitted HWMF submit to the regulatory authority? To get a handle on all of this, one should start by reaching out to the appropriate personnel in the finance or treasury function of the parent corporation to discuss the need for a letter of credit, and the reasons for it. The issuer of a letter of credit is usually designated by the agreements establishing the parent corporation's credit facilities. Often, multiple lenders participate as a syndicate in these credit facilities. The agreements will designate one of the syndicate members to be responsible for issuing letters of credit. The amount of funds available to the borrower under any of these credit facilities is reduced by the total amount of all outstanding letters of credit. The borrower is usually prohibited from going outside these credit facilities to secure a letter of credit.

Even so, organizations receive requests for letters of credit from suppliers, toll manufacturers, transporters, and other parties all the time. These requests can usually be fulfilled within a few days to a week. What's the big deal about obtaining a letter of credit to meet one's financial assurance compliance obligations? The answer to this question can be summed up in one word: "*templates*."

¹ It is important to note that the regulatory authority may step in and require the permittee to secure an alternative financial instrument earlier if it believes circumstances warrant.

Regulatory authorities have a detailed template for each type of permissible financial instrument for financial assurance. Compared to other templates, the template for a letter of credit is not too lengthy. It takes up about a page to a page-and-a-half. However, this template (as with all the other templates) must be followed *verbatim*. The letter of credit must contain every word and punctuation mark in exactly the right place. No exceptions are allowed (at least in theory).

Issuing financial institutions usually do not have a problem with about 90 percent of the language in the template for a letter of credit. Often though, these institutions – especially institutions that are issuing such letters of credit for a particular borrower for the first time – cannot help but request changes to a few words or punctuation marks here and there. Usually after several iterations of exchanging drafts, the parent corporation can prevail upon the issuing institution to issue a letter of credit that fully complies with the regulatory agency’s template. However, this process takes time. It is important to account for such time when trying to secure a letter of credit.

When using a letter of credit to comply with financial assurance, one must also establish a standby trust with a qualified financial institution. The standby trust is where the funds are to be deposited if the regulatory authority ever draws on the letter of credit. As with the issuer of the letter of credit, the financial institution that serves as the trustee is usually designated in the agreements establishing the parent corporation’s credit facilities. Often – but not always – the financial institution serving as the trustee will be the same as the financial institution issuing the letter of credit.

Securing the fully-executed agreement that establishes the standby trust can be even more difficult than securing the letter of credit. This is so for several reasons. First, unlike the template for the letter of credit, the template for the standby trust agreement is quite lengthy. This template contains in excess of 2,500 words and runs for six pages or more. Despite such length, this template must also be followed *verbatim*.

Second, the standby trust agreement must be executed, notarized, and witnessed by both the permittee and the financial institution before it is submitted to the regulatory authority. This doesn’t sound like a big deal. However, the EHS and financial managers responsible for securing these signatures will likely be dealing with personnel at the financial institution with whom they do not often interact. As a result, identifying and engaging with the individuals within the financial institution responsible for the establishment of trusts can be a time-consuming task.

The submittal package for the regulatory authority will consist of the letter of credit, the fully-executed trust agreement, and a letter from the owner of the permitted HWMF that contains the following information: (i) identification of the letter of credit by number, issuing institution and date; (ii) the permitted HWMF’s EPA ID Number; (iii) the permitted HWMF’s name and address; and (iv) and the amount of funds assured by the letter of credit. The good news is that while letters of credit are usually updated on an annual basis to account for inflation or

changes in the status of certain hazardous waste management units (HWMUs), the standby trust agreement ordinarily does not require any such changes.

Since letters of credit negatively impact an organization's liquidity position, there will be pressure on EHS and financial personnel to find ways to minimize this impact. Unfortunately, the permitted HWMF owner's options are limited. Issuers of other alternatives such as surety bonds or insurance may still require collateral in the form of a letter of credit to back up these instruments. Having said that though, an organization may have a particularly good relationship with a surety issuer or an insurer. This relationship may allow for the issuance of a surety bond or insurance policy without the need for collateral. The organization may ultimately not succeed in obtaining such uncollateralized instruments. Nonetheless, it never hurts to inquire about this possibility.

In addition, insurance often is a viable alternative for compliance with financial assurance requirements regarding liability for releases. The reason for this is that insurance is designed to protect against contingencies that may never happen. While every HWMU will close eventually, a release from a HWMU may never happen. Thus, insurers may be more willing to underwrite such risks without the need for any collateral.

The financial institution that serves as the trustee in a standby trust arrangement for financial assurance may also require a "side agreement" with the permittee. This side agreement primarily establishes the financial institution's limited role and limited liability in serving as the trustee. Such a side agreement is not a part of the financial assurance package that is submitted to the regulatory authority.

Switching from the financial test to a letter of credit for the first time can result in quite a paper shuffle. Multiple financial instruments must be secured from different financial institutions, multiple internal and external relationships must be managed, and multiple copies of documents must be signed, notarized, and witnessed. However, with an early start, as well as thoughtful planning and communication, a smooth transition from the financial test to a letter of credit can be accomplished.

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