Letters of Credit in Bankruptcy: What You Need to Know

By Joseph Cioffi

Letters of credit ("LCs") and bankruptcy proceedings. Just the mention of the two in the same sentence can cause uneasiness, if not concern, for many creditors.

When the account party to an LC becomes a debtor in bankruptcy, a conflict can arise between the policies of the Bankruptcy Code which disfavor eve of bankruptcy transfers made for the benefit of one creditor over another and commercial policies which require that the obligation of the issuing bank to pay the beneficiary under the LC be independent of the underlying contract between the beneficiary and the account party.

Potentially at stake in a bankruptcy proceeding is the very “independence doctrine” which makes the LC such an effective commercial device.

One of the underlying goals of the Bankruptcy Code is equality of treatment among similarly situated creditors. To this end, certain “preferred” transfers which meet the requirements of §547 of the Code may be avoided by the debtor or trustee and any amounts transferred recovered. To prove a preferential transfer, the debtor must show that a transfer of the debtor’s property occurred within the preference reachback period for an antecedent debt which benefited a creditor and allowed the creditor to receive more than it would have in a liquidation.

Courts seek to strike a balance between maintaining the independence of LCs while applying the preference provisions of the Code. For the most part, current preference law attempts to preserve the sanctity of LCs.

Under current case law, the payment from the issuing bank to the beneficiary is not a preferential transfer. This rule stems from the fact that the bank uses its own funds, not the funds of the debtor, to pay the beneficiary under the letter. Unsecured LCs, whether documentary or standby, are generally not subject to preference attack. This is so because the debtor is essentially substituting one creditor, the issuing bank, for another, the beneficiary, and there is no resulting diminution of the debtor’s property.

The issuing bank under an unsecured LC, however, may be subject to preference attack if it honors a draft against a letter and is reimbursed by the debtor in the 90-day period prior to the petition. Although the debtor-creditor relationship is generally considered to be created between the debtor and the bank when the letter is issued, the debt is contingent until the bank honors the letter. Thus, the reimburse-
ment is considered to be for an antecedent debt.

In addition, the issuing bank under an unsecured LC may be subject to preference attack if it obtains and perfects a security interest in the debtor’s property within the preference reachback period. This is a result of the rule that a transfer of the debtor’s property occurs when the collateral is perfected by the issuing bank, not when the issuing bank honors the letter.

Consequently, a secured LC may be considered a preferential transfer. However, the issuing bank may be able to defend against a preference attack by showing that it gave “new value” for the debtor’s collateral in a contemporaneous exchange by way of the LC itself. The new value defense probably does not save the beneficiary from an indirect preference attack since any payment it receives is made possible by the transfer of the debtor’s property to the bank.

In addition to the new value exception contained in the preference provisions of the Code, a creditor may stave off a preference attack if it can show that the LC is used as method of payment in the “ordinary course of business.” However, a recent case illustrates why these so-called “safe harbors” are not a panacea for creditors facing a preference attack. In a very restrictive interpretation of the safe harbor provisions, the Seventh Circuit in Matter of P.A. Bergner & Co., 140 F.3d 1111 (7th Cir. 1998), recently found that eve of bankruptcy debits to a debtor’s deposit accounts by an issuing bank were preferential.

In Bergner, the bank issued LCs under a master agreement which required the debtor to pay the bank any amount drawn on the letter on or before such amounts were paid by the bank to the beneficiary. (The master agreement was secured by the debtor’s deposit accounts held at the bank, however, the Court found that the bank failed to perfect its security interest because it never “seized” or restricted the deposit accounts prior to the draw on the letter as required under common law.)

One LC, which was used in a commercial transaction, was drawn upon within 90 days of the bankruptcy filing. On the same day, the debtor deposited sufficient funds in its accounts to cover the draw with the bank. The bank paid the beneficiary and debited the debtor’s account.

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Even though the Bankruptcy Code does not dictate which entity must actually confer new value on the debtor,
the Court in *Bergner* appeared to be influenced by the fact that the beneficiary, not the bank, gave new value to the debtor.

It remains to be seen whether other courts will follow the *Bergner* court’s narrow interpretation of the safe harbor provisions of the Code. In the meantime, bankruptcy case law addressing potential conflicts between the independence doctrine and preference theory continues to evolve as new arrangements and new arguments are presented to the courts, limited only by the creativity of the parties.


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**Practical Tips: Lender Beware**

**Demand Notes May Not Mean Payment on Demand**

By Jessica Sklute

A federal court in Georgia recently decided that a lender may have the obligation to issue the full line of credit to its borrower and may not terminate the borrower’s line of credit unless an event of default enumerated in the loan agreement has occurred even where a demand note has been executed. With respect to the obligation to issue the full line of credit, the court reasoned that the term “line of credit” does not relieve the lender of an obligation to advance funds otherwise set forth in an agreement. With respect to the ability to terminate, the court concluded that where an agreement has provisions for repayment or default in the event of certain contingencies as this may defeat the purpose of the demand note and prohibit the termination of the line of credit unless the borrower is in default. (Coffee v. General motors Acceptance Corporation, 5F. Supp. 2nd 1365 (S.D.Ga. 1998))

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**RECENT DEVELOPMENTS**

**Bank Arbitration**

by Linda Gerstel

The California Court of Appeals recently held that a bank cannot change its existing bank and credit card account agreements simply by mailing customers an insert adding an alternative dispute resolution provision clause to their account agreements. Bank of America mailed out “bill stuffers” to its personal credit card and deposit account customers informing them that from that time forward any dispute that customers had with the bank would be resolved by arbitration. Bank of America argued that the “change of terms” provision, included in the existing account agreements, gave the bank a unilateral right to modify the original account agreements, gave the bank a unilateral right to modify the original account agreements. The original account agreements did not contain an ADR provision or address the method or forum for resolving disputes.

The trial court granted Bank of America’s motion for summary judgment. The lower court ruled that the “change of terms” provision, included in the existing account agreements, gave the bank a unilateral right to modify the original account agreements. The original account agreements did not contain an ADR provision or address the method or forum for resolving disputes.

The Court of Appeals reversed and found “the bank’s interpretation of how broadly it may exercise that right, with no limitation... as long as it complies with the de minimis procedural requirement of notice, virtually eliminates the good faith and fair dealing.

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A deposit account or credit card account... implicates the right to a jury trial. ... however, the bank’s interpretation of the change of terms provision would dispense with... the right to a jury trial... and [such a right] is not lightly to be deemed waived.” (Badie v. Bank of America, Calif. App. Ct., No. A068753, Phelan, J., 11/4/98).

Recovery of Co-Guarantors
By Jessica Sklute

A 1998 New York Federal Court decision held that a guarantor who purchases an assignment of a demand note and a guaranty can only recover from another guarantor the co-guarantor’s pro-rata share of the debt. The guarantors refinanced a loan in connection with a business which the guarantors had formed. Co-guarantors executed a demand note on behalf of a business which they had formed, in favor of a lender and both guarantors executed personal guarantees of the demand note. The guarantor later borrowed funds from another bank and paid off the lender, taking an assignment of the lender demand note and the guaranty of the co-guarantor. The guarantor then demanded payment from the business and the co-guarantor.

The court granted summary judgment to the guarantor as to the liability of the business but granted summary judgment against the co-guarantor only as to liability on the payment and not as to the amount since a guarantor suing another guarantor cannot recover more than the co-guarantor’s pro-rata share. The court reasoned that while a guarantor who has paid off a claim on which it was legally liable may subsequently seek contribution from a co-guarantor, the recovery is limited because the guarantor’s right to contribution depends on its having paid an amount greater than it was obligated to pay as between itself and the co-guarantor. Thus the guarantor could recover from the co-guarantor to the extent the guarantor paid the lender in excess of the amount it was obligated to pay. Citing equitable consideration, the court rejected the guarantor’s claims that it was suing the co-guarantor not as a co-guarantor but as an assignee and was entitled to recover 100% of the amount due on the note. (Backman v. Hibernia Holdings Inc., 1998 WL 427675 (S.D.N.Y.))