Article

Thinking of Taking a Letter of Credit As Additional Collateral in That Workout? Think Again!

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The Problem
Taking a letter of credit as collateral from a borrower teetering on the edge of bankruptcy is considered one of the safest things for a lender to do. After all, the "independence principle" provides that a letter of credit and its proceeds are not part of the debtor's estate in a bankruptcy.[1] Letter of credit drawings must be paid even if the borrower goes bankrupt. Regardless, the lender may have to give up all proceeds from the letter of credit.

The problem is that under Section 547 of the U.S. Bankruptcy Code the proceeds a lender receives from that letter of credit within the "preference period" (90 days before the borrower files bankruptcy, or 1 year if the issuer of the letter of credit is an insider), may be avoided as a preferential transfer.[2] As a result, the lender may have to deliver those proceeds to the trustee in the borrower's bankruptcy. The injunction issued against payment of a letter of credit in the 1979 case commonly referred to as "In re Twist Cap"[3]finally got legs in the 1987 U.S. 5th Circuit case commonly referred to as "In re Compton" or "Blue Quail."[4] In that case the borrower, after defaulting on its obligation to the lender, paid the issuer to issue a letter of credit in the lender's favor. Under the terms of the letter of credit, the issuer would be required to pay the lender if the borrower failed to cure its default to the lender by a certain date. As security for issuing the letter of credit, the issuer received collateral from the borrower. Since the collateral for the letter of credit was given contemporaneously with its issuance, it was not an avoidable preference because the collateral was given as consideration for a new obligation (the application for the letter of credit) which supported the issuance of the letter of credit. However, for the lender, the letter of credit issued in its favor was not supported by new value because the lender received the letter of credit to secure an antecedent (i.e. existing) unsecured debt.

Letter of Credit or Indirect Preferential Transfer?
The goals of the Bankruptcy Code include making sure a debtor does not prefer one creditor over another by giving a creditor part of the debtor's property as collateral during the preference period as additional security on an existing debt. In the Blue Quail case, had the collateral given to the letter of credit issuer instead been given to the lender as additional collateral for its antecedent debt, it would have been avoidable as a preference.
In Blue Quail, however, the collateral was given to a new creditor, the letter of credit issuer, for a new debt, the application for the letter of credit. Thus, from the perspective of the issuer, neither the letter of credit nor the payment by the issuer to the lender is a preferential transfer. However, from the perspective of the lender, the court in Blue Quail determined that the payments made by the issuer to the lender were recoverable as a result of indirect preferential transfers. The court's direct/indirect distinction focused on who benefited from the transfer. Therefore, while the transfer was not a direct transfer from the debtor to the lender, the lender did benefit from the debtor's actions. The court reasoned that the effect of the issuance of the letter of credit to secure the unsecured antecedent debt of the lender was to allow the lender to receive a greater percentage of the proceeds of the debtor, because the other creditors of the debtor could not receive the proceeds from the sale of the collateral pledged to secure the application for the letter of credit. Pledging of the collateral to the letter of credit issuer was an indirect transfer to the lender, who benefited by subsequently receiving the letter of credit proceeds. While the direct transfer of the collateral to the letter of credit issuer was not a preference,

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the indirect transfer to the lender was a preference. The lender had to give the letter of credit proceeds to the trustee in the borrower's bankruptcy.

The direct/indirect approach taken in Blue Quail has been criticized by some courts because it identifies "transfer" with "benefit."[5]Those cases indicate that the Bankruptcy Code's preference statute addresses only a single transfer in any instant. They argue that merely because more than one party may derive a benefit from such a transfer does not imply that a single transfer is transformed into multiple transfers. Despite these arguments, the analysis and reasoning in Blue Quail will most likely be applied by courts addressing situations that are factually similar. Under Blue Quail, a "creditor cannot secure payment of an unsecured antecedent debt through a letter of credit transaction when it could not do so through any other type of transaction."[6]

Solutions
What is a lender to do? One solution is for the letter of credit issuer to contractually agree that it will not receive collateral in consideration for the issuance of the letter of credit. If there is no direct transfer, there is no indirect transfer.

Another solution is to have the letter of credit issued only for the value of the collateral securing the lender's debt, or make sure the letter of credit permits partial drawings for that amount. This assumes none of the lender's existing collateral is subject to avoidance as a preference, and a release of any lien on existing collateral would not provide junior creditors a preference over other creditors. Letter of credit proceeds would not be a preference if the lender is already secured by that same amount in such other collateral. The lender may have to give up the collateral, but not the letter of credit proceeds.

What good is this? If the borrower is not insolvent at the time the letter of credit is issued, or if it is insolvent, does not enter bankruptcy within the preference period, the lender would not have to disgorge the letter of credit proceeds at all, and the lender's collateral position is improved. If the borrower is insolvent at the time the collateral is pledged to secure the application for the letter of credit, and the borrower enters bankruptcy within the preference period, the lender does not have to go through the bankruptcy for a motion to lift stay to foreclose on the collateral. Instead, it would deliver the collateral to the trustee in bankruptcy and collect the letter of credit proceeds in the amount of the value of the collateral, outside of the borrower's bankruptcy.

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[1]Under the independence principle, an issuer's obligation to the letter of credit's beneficiary (e.g. the lender) is independent from any obligation between the beneficiary and the issuer's customer (e.g. the borrower).
[2] 11 U.S.C. § 547.
[3]In re Twist Cap., Inc., 1 B.R. 284 (Bankr. M.D. Fla. 1979).
[4]Blue Quail Energy, Inc. v. MBank Abilene (In re Compton Corp.), 831 F.2d 586, 591 (5th Cir. 1987).
[5]See In re C-L cartage Co., Inc., 899 F.2d 1490 (6th Cir. 1990); Levit v. Ingersoll Rand Fin. Corp., 874 F. 2d 1186, 1195 (7th Cir. 1989); In re Westex Foods, Inc., 950 F.2d 1187 (5th Cir. 1992).
[6]Blue Quail Energy, Inc., 831 F.2d at 594.

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