

CHAPTER

SIX

U.C.C. ARTICLE 5 AND INSOLVENCY LAW

A. SCOPE AND OPERATION OF ARTICLE 5

Uniform Commercial Code (U.C.C.) Article 5 deals with letters of credit. A “letter of credit” is defined as a definite undertaking in a record authenticated (1) by a signature or authenticated in accordance with an agreement or the standard practice of financial institutions that regularly issue letters of credit, (2) by an “issuer” (U.C.C. § 5-102(a)(9)—usually a bank) to a “beneficiary” (U.C.C. § 5-102(a)(3)—the person who, under the terms of the credit, is entitled to have its complying presentation honored), (3) at the request or for the account of an “applicant” (U.C.C. § 5-102(a)(2)—the person at whose request or for whose account a credit is issued) which, in the case of a financial institution, may be itself or for its own account, (4) to honor a documentary presentation by payment or delivery of an item of value. *See* U.C.C. § 5-102(a)(10). Credits are either commercial, such as a credit issued with the seller of goods as the beneficiary in order to assure payment on behalf of the buyer (*see* U.C.C. Article 2 § 2-325), or standby, such as a credit issued with the

owner of a building under construction as the beneficiary in order to assure money for performance should the contractor default. See *J.P. Morgan Trust Co., N.A. v. U.S. Bank, N.A.*, 381 F. Supp. 2d 865 (E.D. Wisc. 2005). The Uniform Customs and Practice for Documentary Credits (ICC Publication No. 500, 1994) often supplements commercial letters of credit; International Standby Practices 98 (ICC Publication, 1998) often supplements standby letters of credit. See U.C.C. § 5-116(c).

B. PREFERENTIAL TRANSFERS

1. THE BASIC PREFERENCE ISSUE

With some exceptions in Bankruptcy Code § 547(c) and (i), § 547(b) allows a debtor's trustee in bankruptcy to avoid a pre-bankruptcy transfer of the debtor's property (1) to or for the benefit of a creditor, (2) for or on account of an antecedent debt that was made (i) while the debtor was insolvent and (ii) on or within ninety days before bankruptcy (longer if the transfer was made to an "insider") and (3) if the transfer enables the creditor to receive more than it would in a Bankruptcy Code Chapter 7 liquidation case considering the transfer as not made. See *generally supra* Chapter Two, Part E.5.

Suppose, for example, that a seller of goods makes a presentation under a commercial letter of credit that was issued at the request of the buyer, who is bankrupt. The payment would certainly provide the seller with more than the seller could expect from an unsecured claim in the buyer's bankruptcy. However, because the payment is neither the funds nor the property of the buyer but rather is the property of the issuer, payment under the letter of credit does not fall under Bankruptcy Code § 547 and also does not violate the automatic stay under Bankruptcy Code § 362. See *In re Stonebridge Technologies, Inc.* 430 F.3d 260 (5th Cir. 2005) (letter of credit and its proceeds are not property of the estate under Bankruptcy Code § 541; cap on damages for breach of rejected lease does not preclude draw on letter of credit where lessor never filed proof of claim) and, *supra*, Chapter Two, Part B. But see *AMP Property, L.P. v. Official Creditors* for the

Estate of AB Liquidating Corp., 416 F.3d 961 (9th Cir. 2005) (where proof of claim filed), and *In re Onecast Media, Inc.*, 439 F.3d 558 (9th Cir. 2006) (while stating letter of credit proceeds are not property of the estate, the court upheld a possible claim of the trustee to proceeds of a letter of credit that was a security deposit to the extent the proceeds exceeded the landlord's damage claim when the lease provided that any balance of the deposit after all obligations against it were fulfilled would be returned to the tenant debtor). In addition, in the case of debt owed by the applicant to the issuer in reimbursement and that is secured by an unavoidable security interest from the buyer, when the issuer receives that reimbursement from the buyer as it is entitled to under U.C.C. § 5-108(i)(1), it will be for a contemporaneous exchange of value (reduction of the issuer's secured claim) under Bankruptcy Code § 547(c)(1), and the repayment results in no improvement in position because the release of the collateral is value for the transfer in reimbursement. Of course, in this instance, relief from the automatic stay of Bankruptcy Code § 362 must be obtained for the payment from the buyer/debtor. The standard analysis described above reflects the "independence principle" (that the issuer's obligation is independent of applicant defenses not stated in the letter of credit) and recognizes that the bankruptcy preference rules are not designed to avoid ordinary sales and finance transactions. See Michael St. Patrick Baxter, *Letters of Credit and the Powerine Preference Trap*, 53 BUS. LAW. 65, 69 (1997); *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293 (11th Cir. 1988); *In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987), *reh'g granted*, 835 F.2d 584 (5th Cir. 1988). See generally *supra* Chapter Two. This analysis does not necessarily settle all issues, however.

2. VARIATIONS ON THE PREFERENCE THEME

To illustrate what other issues can be involved, consider *In re P.A. Bergner & Co.*, 140 F.3d 1111 (7th Cir. 1998). The difference in *Bergner* was the failure to provide security for the issuer's reimbursement claim; as a result, when the claim was paid, there was no exchange of value and the transfer fit within Bankruptcy

Code § 547(b) in all respects. *Bergner* is a troubling case, however, as the bankruptcy estate not only was allowed to recover reimbursement to the issuer from the debtor as voidable preferences, but it also benefited from the issuer's payment pursuant to the letter of credit. This clearly was not the purpose of the preference rules and seems inconsistent with the equitable nature of the bankruptcy process. See Code §§ 105(a), 510(c); *Pepper v. Litton*, 308 U.S. 295 (1939) (equitable subordination of claims); see also *In re Powerine Oil Co.*, 59 F.3d 969 (9th Cir. 1995) (in which the debtor paid its unsecured obligation to the creditor-beneficiary instead of defaulting and causing the beneficiary to draw on the letter of credit; as a result, the beneficiary did not draw on a credit that would have provided payment in full and which subsequently expired before the bankruptcy preference action).

However, in a similar scenario, the preferential payment can be defended as a contemporaneous exchange for new value protected by Bankruptcy Code § 547(c)(1), to the extent that the assets securing the reimbursement obligation by the debtor to the issuer were released by the debtor's payment of the obligation owed to the beneficiary. For a detailed examination and a somewhat different view of this issue, see David Gray Carlson and William H. Widen, *Letters of Credit, Voidable Preferences, and the "Independence" Principle*, 54 BUS. LAW. 1661 (1999).

There is more, however. *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 296–99 (11th Cir. 1988), involved a standby letter of credit for an outstanding debt and an undersecured reimbursement claim. The 11th Circuit determined (1) that the beneficiary had received a preference indirectly because the collateral for the reimbursement claim actually benefited the beneficiary; (2) that the beneficiary had not given new value because the debt paid was an antecedent one; (3) that, accordingly, neither the Bankruptcy Code § 547(c)(1) exception nor the Bankruptcy Code § 547(c)(2) exception for an ordinary course transfer applied; and (4) that, under Bankruptcy Code § 550(a)(1), recovery could be had from the transferee of the reimbursement (the issuer) or the person for whose benefit the transfer was

made (the beneficiary). However, to preserve the value of the letter of credit, the court allowed the issuer to pay out under the letter and keep the actual collateral, and the court limited the recovery from the beneficiary to the value of the collateral transferred to the issuer by the debtor on behalf of the antecedent debt. *See also* the subsequent comment on the theory and the case in *In re Richmond Produce Co., Inc.*, 118 B.R. 753 (Bankr. N.D. Cal. 1990); *In re C-L Cartage Co.*, 899 F.2d 1490 (6th Cir. 1990); Michael St. Patrick Baxter, *Letters of Credit and the Powderine Preference Trap*, 53 BUS. LAW. 65 (1998). *See also* Bankruptcy Code § 547(i), which provides that if the trustee avoids a transfer made between 90 days and one year before the petition by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, the transfer will be considered to be avoided only with respect to the creditor that is an insider.

Bankruptcy Code § 550 came up also in *In re 360networks (USA) Inc.*, 338 B.R. 194 (Bankr. S.D.N.Y. 2005). The court stated that in as much as liability among an initial transferee and the entities for whose benefit the transfer was made is coextensive, there is no reason that one such party cannot raise defenses that are available to other such parties.

C. APPLICANT INSOLVENCY

Under U.C.C. § 5-109(b), a court may enjoin an issuer from honoring a presentation (even though the final resolution of the underlying fraud claim will not occur in that court—*see Hendricks v. Bank of America, N.A.*, 398 F.3d 1165 (9th Cir. 2005), amended and superseded on other grounds by 408 F.3d 1127 (9th Cir. 2005)), if (1) customary equitable conditions are met, (2) the relief is not prohibited by law (*see Union Export Co. v. N.I.B. Intermarket, A.B.*, 786 S.W.2d 628 (Tenn. 1990) (injunction against payment or attachment invalid if issued after issuer accepted time draft drawn under the letter of credit)), (3) the parties who may be adversely affected are adequately protected, (4) the applicant is more likely than not to succeed, and (5) the claim is that there is a forged or materially fraudulent required

document or that honor would facilitate a material fraud by the beneficiary on the issuer or applicant. The issuer's inability to obtain reimbursement after honoring the letter of credit as otherwise provided in U.C.C. § 5-108(i)(1) (because, for example, the applicant is in bankruptcy and the issuer's claim is undersecured) is not an excuse for dishonor. See *In re Tabernash Meadows, LLC*, 56 U.C.C. Rep. Serv. 2d 622 (Bankr. D. Colo. 2005) (neither the letter of credit nor its proceeds are property of the estate); *Fisher v. Dakota Community Bank*, 405 F. Supp. 2d 1089 (D.N.D. 2005); but see *Al Makaaseb General Trading Co. v. U.S. Steel Int'l., Inc.*, 412 F. Supp. 2d 485 (W.D. Pa. 2006) (no fraud), and *New Orleans Brass, L.L.C. v. Whitney Nat'l Bank*, 818 So.2d 1057 (La. Ct. App. 2002) (no fraud—only breach of contract). In *Wysko Investment Co. v. Great American Bank*, 131 B.R. 146 (D. Ariz. 1991), the court further held that an issuer's obligation to honor the letter of credit could be enjoined, when necessary, for an applicant's reorganization prospects under Bankruptcy Code § 105. In *In re Twist Cap, Inc.*, 1 B.R. 284 (Bankr. D. Fla. 1979), the court held the contract between the bank and the beneficiary of the letter of credit was still executory and could be rejected by the applicant debtor-in-possession and any payment to the beneficiary would be indirectly made by the debtor. Although federal law is paramount to state law, cases like *Wysko* and *In re Twist Cap*, particularly *Twist Cap*, involve questionable analysis and are not in line with the overwhelming weight of jurisprudence because, beyond the limited fraud exception of state law, they ignore the independence principle that underlies letter of credit law.

Of course, even though the applicant's insolvency is not an excuse not to pay, in such cases the issuer may scrutinize the beneficiary's documents for compliance with the letter of credit's terms because a noncomplying presentation justifies dishonor, and the strict compliance standard under U.C.C. § 5-108(a) also facilitates such an approach. See *Middlesex Bank & Trust Co. v. Mark Equip. Corp.*, 56 U.C.C. Rep. Serv. 2d 443 (Mass. Super. Ct. 2005); *Cont'l Cas. Co. v. SouthTrust Bank, N.A.*, 933 So. 2d 337 (Ala. 2006); *W. Sur. Co. v. N. Valley Bank*, 58 U.C.C. Rep.

Serv. 2d 790 (Ohio Ct. App. 2005). In *Suntex Industrial Corp. v. CIT Group BBC, Inc.*, 2001 WL 34401367 (D. Del. 2001), a guarantor of the issuer's reimbursement claim, rather than the issuer, used this approach (the guarantor was required to approve waiver of any discrepancies in the presentation). The result was the same, however, and the court upheld the guarantor's right to refuse waiver.

If there is dishonor, then under U.C.C. § 5-108(b) the presenter must receive appropriate notice of discrepancies, even if honor at the time is precluded because of an injunction or another reason. *Heritage Bank v. Redcom Lab., Inc.*, 250 F.3d 319 (5th Cir. 2001). In this regard, failure to mention fraud, forgery, or expiration does not preclude asserting such as a basis for dishonor, but establishing fraud under U.C.C. § 5-109 is extraordinarily difficult, particularly in terms of a so-called suicide credit (one in which only a draft need be presented in order to draw). *See, e.g., Synergy Ctr., Ltd. v. Lone Star Franchising, Inc.*, 63 S.W.3d 561 (Tex. Ct. App. 2001); *W. Sur. Co. v. Bank of S. Oregon*, 257 F.3d 933 (9th Cir. 2001). An issuer has a reasonable time after presentation but not beyond the end of the seventh business day after the receipt of the documents to honor or to give notice of discrepancies. In *In re Montgomery Ward, LLC*, 292 B.R. 49 (Bankr. D. Del. 2003), the seller had delivered the goods and presented the documents and then the buyer went bankrupt. The court held the seven day period was to give the issuer time to examine the documents and did not give a right to avoid payment under the letter of credit.

Other risks arising when bankruptcy occurs include the situation in *In re Metrobility Optical Systems, Inc.*, 268 B.R. 326 (Bankr. D.N.H. 2001), where a lessor drew under a standby letter of credit when its lessee allegedly defaulted under the lease because of bankruptcy. The court enjoined the draw on the basis that the condition of the credit (the default of the lessee) had not occurred, in part because Bankruptcy Code § 365(e)(1)(B) invalidates a so-called ipso facto clause declaring a default on the basis of bankruptcy alone, (but see § 521(d)), and in part because asserting a default violated the automatic stay of Bankruptcy Code § 362. *See,*

however, the *In re Stonebridge Technologies* case, *supra*, Chapter 4 at C. Executory Contracts and Unexpired Leases, and, *generally, supra* Chapter Two, Part B.

In re Dairy Mart Convenience Stores, Inc., 272 B.R. 66 (S.D.N.Y. 2002), constitutes another warning for drafters of letters of credit. New England Dairies sued Dairy Mart and obtained prejudgment relief of \$2,750,000. To stay enforcement, the court approved Dairy Mart's submission of a letter of credit and ordered its renewal annually during the sixty days before it would expire. Dairy Mart then filed bankruptcy. New England Dairies obtained relief from the automatic stay and proceeded toward final judgment; however, final judgment had not yet been rendered when the letter of credit was due to expire. The bankruptcy court refused to mandate renewal, as it would have required the debtor to post additional collateral that would have depleted the estate by way of a post-petition preference. Because the letter of credit was not automatically renewable and New England Dairies could therefore not draw, it was unable to obtain the proceeds of the letter of credit to secure its award before the letter of credit expired.

In re Papio Keno Club, Inc., 262 F.3d 725 (8th Cir. 2001), exposes yet another risk to a beneficiary, perhaps not limited to, but certainly exacerbated by, the bankruptcy context. Here, the beneficiary drew on the letter of credit. After the applicant filed bankruptcy, the trustee sought to recover a large portion of the payment upon grounds that it represented unreasonable liquidated damages for breach of the underlying agreement. The court required a refund, even though, technically, the paid funds belonged, and arguably should have been returned, to the issuer. The court considered that the independence principle behind letter of credit law applied with respect to distributing the proceeds of a letter of credit, but here the claim was on the underlying contract instead. *See also In re Graham Square, Inc.*, 126 F.3d 823 (6th Cir. 1997), which employed a similar analysis.

In *In re Farm Fresh Supermarkets of Maryland, Inc.*, 257 B.R. 770 (Bankr. D. Md. 2001), a letter of credit in essence "rode through" the applicant's bankruptcy. *See generally supra* Chap-

ter Two. In this case, the letter of credit was furnished to secure a lease. When the lessee filed bankruptcy, the lease defaults were cured and the lease was assigned (see the discussion *supra* in Chapter Four). When the assigned lessee then also defaulted, the landlord drew on the letter of credit. The draw was upheld against the argument that it constituted an invalid post-petition transfer of property of the estate, as the court believed that to hold otherwise would undermine its order authorizing the lease assignment.

D. OTHER INSOLVENCY ISSUES

1. ISSUER INSOLVENCY

What is the status of the beneficiary, particularly the beneficiary of a standby letter of credit, when the issuer of a credit is insolvent rather than the applicant? At one point, U.C.C. § 5-117 gave a letter of credit beneficiary priority over other creditors to the extent of any applicant collateral held by an insolvent issuer to secure reimbursement. This probably would not have been effective in cases involving federal law. *See, e.g.,* United States v. BCCI Holdings (Luxembourg), S.A., 919 F. Supp. 31 (D.D.C. 1996); Jennings v. U.S. Fid. & Guar. Co., 294 U.S. 216 (1935). U.C.C. § 5-117 was deleted when Article 5 was last revised in favor of other controlling law. Moreover, considering the prevalence of depositor preference statutes regarding insolvent banks, there is little likelihood that a beneficiary of a bank-issued letter of credit will be in line for payment anyway. If a claim is pressed, however, administrative remedies must be exhausted (see *Pennsylvania v. FDIC*, 881 F. Supp. 979 (E.D. Pa. 1995)), and the claim's classification will be affected by whether the claim was unconditionally fixed on the day of insolvency. *See* *Del E. Webb McQueen Dev. Corp. v. RTC*, 69 F.3d 355 (9th Cir. 1995).

2. TRANSFERABILITY AND SUBROGATION

Unless a letter of credit provides that it is transferable, the right of a beneficiary to draw or otherwise demand performance under

a letter of credit may not be transferred. U.C.C. § 5-112(a). Suppose the beneficiary of a letter of credit is insolvent. Can that beneficiary's rights under the letter of credit be exercised by its trustee in bankruptcy or by the Federal Deposit Insurance Corporation (FDIC) in the case of an insolvent bank? It would seem that a state law or contractual restriction such as U.C.C. § 5-112(a) must give way to federal law, and the cases concur. *See, e.g.,* Chatham Ventures, Inc. v. FDIC, 651 F.2d 355 (5th Cir. 1981); *Pastor v. Nat'l Republic Bank of Chicago*, 390 N.E. 2d 894 (Ill. 1979); *FDIC v. Bank of Boulder*, 865 F.2d 1134 (10th Cir. 1988), *reh'g granted*, 911 F.2d 1466 (10th Cir. 1990). U.C.C. § 5-113 now affirms these results and provides appropriate protection for the issuer.

Subrogation has been called an equitable assignment. Prior to the last revision of U.C.C. Article 5, subrogation often was denied in the letter of credit context because of the independence principle. Thus, in *In re East Texas Steel Facilities, Inc.*, 41 U.C.C. Rep. Serv. 2d 1201 (N.D. Tex. 2000), the issuer was denied subrogation to the rights of the beneficiary seller that the issuer had paid. The issuer sought to exercise the right of the seller to reclaim the goods sold under U.C.C. § 2-702, as discussed *supra* in Chapter Four. The *East Texas Steel* court relied upon Bankruptcy Code § 509(a), which only allows subrogation for "an entity that is liable with the debtor on a claim of a creditor against the debtor." *But see In re Valley Vue Joint Venture*, 123 B.R. 199 (Bankr. E.D. Va. 1991) (bank, by honoring a letter of credit and thereby reducing the debtor's obligation to the beneficiary, is "an entity that is liable with the debtor on a claim of a creditor against the debtor"). Whether U.C.C. § 5-117, which now specifically provides for subrogation, will influence the proper interpretation of Bankruptcy Code § 509 remains to be seen. In *In re Hamada*, 291 F.3d 645 (9th Cir. 2002), the bank issued a letter of credit on the debtor's behalf; this enabled the debtor to obtain a supersedeas bond to prevent execution on a judgment for fraud. The bank then asserted that its indemnification claim against the debtor, like the debtor's judgment debt to the victim of the fraud, was excepted from discharge on a subrogation theory. The court held under Bankruptcy Code § 509 that one who is liable with

the debtor on a debt and who pays the debt is subrogated to the rights of the former creditor, but as the bank was liable on the letter of credit, an independent obligation, not equivalent to a guaranty or secondary liability on the debt, the bank was not liable with the debtor on the obligation owed to the judgment creditor and thus was not subrogated. On the other hand, in *JPMorgan Chase Bank v. Cook*, 52 U.C.C. Rep. Serv. 2d 999 (S.D.N.Y. 2004), the court stated that U.C.C. § 5-117 permits the issuing bank to subrogate to the beneficiary and pursue the applicant for the amount the applicant owes where there is no danger of double recovery. There also is the concurring opinion of Judge Klein in *In re Mayan Networks Corp.*, 306 B.R. 295 (B.A.P. 9th Cir. 2004), where the opinion is expressed that U.C.C. § 5-117 did away with old distinctions and there is no reason now under revised U.C.C. Article 5 to treat letters of credit any differently than other guarantees in bankruptcy proceedings (which perhaps goes a bit far). In the end, a specific written assignment from the beneficiary may be wise.

3. D'OENCH DUHME DOCTRINE

If the beneficiary of a letter of credit is an insolvent bank, then does the issuer lose further possible defenses against the beneficiary in addition to the previously discussed defense against transferability that is lost due to federal law? The only recognized defense to honor, beyond asserting that the presentation is not in compliance with the terms of the letter of credit (U.C.C. § 5-108(a)), is that a required document is forged or materially fraudulent or that honoring the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant. See discussion *supra* this chapter, Part C. But when the beneficiary bank is insolvent and the FDIC makes the presentation, the doctrine of *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), and the provisions of 12 U.S.C. § 1823(e) have been applied to protect federal agencies against alleged oral agreements invoked by the issuer. See *supra* Chapter Five at A.3, and, in particular, *YNN Holding Corp. v. FDIC*, 354 F. Supp. 2d 1334 (S.D. Fla. 2005).

Further, in *FDIC v. Bank of San Francisco*, 817 F.2d 1395 (9th Cir. 1987), the court limited the fraud defense (to an even greater extent than under state law alone) to fraud in the presentation of the required documents on the basis that to permit a greater fraud defense would reduce the protection that federal policy provides the FDIC. Moreover, to the extent that federal policy gives the FDIC holder-in-due-course status (*see* *Gunter v. Hutcherson*, 674 F.2d 862 (11th Cir. 1982); *but see In re Woodstone Ltd. P'ship*, 133 B.R. 678 (Bankr. E.D.N.Y. 1991) (declining to follow the *Gunter* case); *Langley v. FDIC*, 484 U.S. 86 (1987) (overruling the *Gunter* case on the point of the relevance of knowledge by the FDIC of a representation prior to its acquiring the note)), any fraud or forgery defense is fully eliminated under U.C.C. § 5-109(a)(1). Finally, in *FDIC v. Vogel*, 437 F. Supp. 660 (E.D. Wis. 1977), the court also refused to permit an applicant to maintain an alleged defense based upon asserted oral agreements made in connection with the letter of credit transaction. *But see* *FDIC v. Rivera-Arroyo*, 645 F. Supp. 511 (D.P.R. 1986), in which the court declined to follow the expansive view in the *Vogel* case. On the other hand, the argument of the FDIC against honor based upon the *D'Oench* doctrine was not successful in a case in which the issuer of the letter of credit was in violation of a regulatory cease and desist order, improperly entered the letter of credit on its books, and subsequently was declared insolvent. *Murphy v. FDIC*, 38 F.3d 1490 (9th Cir. 1994).