Abstract for March 29, 2019 CLE Program

Letters of Credit & Applicant Bankruptcy: U.S. & Canadian Bankruptcy Provisions and Cases for Beneficiaries, Issuers, Applicants & Others

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This program examines the effect on a letter of credit (LC) transaction of the U.S. or Canadian bankruptcy of the applicant (Applicant) for the LC. Questions explored include:
May the beneficiary (Beneficiary) of the LC draw on the LC or is it stayed from drawing because of the bankruptcy proceeding?

May the issuer (Issuer) of the LC pay a facially complying drawing on the LC or is it stayed from doing so because of the bankruptcy proceeding?

If the Issuer pays the LC drawing, may the Beneficiary keep the LC proceeds?

If the Issuer pays the LC drawing, is it entitled to be reimbursed?

If the Issuer has been reimbursed, is it entitled to keep the reimbursement?

What happens if the Beneficiary fails to draw on the LC?

We discuss relevant statutory provisions and cases from both sides of the U.S.-Canadian border and consider practical steps the parties may take to avoid unexpected results in a bankruptcy proceeding. For example, Comm. of Unsecured Creditors v. Koch Oil Co. (In re Powerine Oil Co.), 59 F.3d 969, 971 (9th Cir. 1995), shows how an LC Beneficiary can be better off when an Applicant that owes money to it defaults rather than paying the debt - unless the LC is structured differently than the LC was structured in that case. To avoid falling into the Powerine trap, we show how to either use a so-called direct-draw or direct-pay LC (rather than a pure standby LC) or use a standby LC to provide preference “clawback” coverage – essentially using the LC to obtain “preference-proof” funds from the Issuer and to return to the Applicant’s bankruptcy estate the payment from the Applicant that may be subject to disgorgement as preferential.

Among the subtopics covered are:

- the independence principle of letters of credit,
- the automatic stay in bankruptcy,
- equitable powers of bankruptcy courts,
- property of the bankruptcy estate,
- *ipso facto* clauses,
- Issuer’s payment with “its own funds,”
• avoiding drawing conditions that require taking action against Applicant or its property,

• preferences, indirect preferences, and other avoidable transfers,

• direct-draw or direct-pay LCs versus pure standby LCs,

• setoffs,

• the U.S. cap on damages for breach of a real estate lease,

• subrogation,

• collateral security,

• claims estimation, and

• why most LCs issued by U.S. banks are issued with an initial term not exceeding one year (although an LC may contain an auto-extension or evergreen clause providing for an annual extension of the term of the LC).

For example, we examine why U.S. courts have ruled almost universally that “a letter of credit and the proceeds thereof are not property of the debtor’s bankruptcy estate,” and the consequences for LC transactions. E.g., Michael St. Patrick Baxter, Letters of Credit and the Powerine Preference Trap, 53 Bus. Law. 65, 66 (1997). And if LCs and their proceeds are not property of the Applicant’s bankruptcy estate, what are the consequences for the application of the U.S. Bankruptcy Code § 502(b)(6) cap on damages for breach of a lease for real estate – the cap provides for disallowance of “the claim of a lessor for damages resulting from the termination of a lease of real property” to the extent such claim exceeds a formula:

Is an LC payment by the Issuer to the Beneficiary subject to recovery for exceeding the cap where the Applicant is the tenant?

Where the bankrupt Applicant’s reimbursement obligation to the Issuer is fully secured and exceeds the cap, should the LC proceeds be treated as if they were paid by the Applicant as damages for breach of the lease? Or are the LC proceeds more properly treated like an independent payment from a third party, especially if characterized as supporting obligations rather than as rent or as damages for breach or termination of the lease?
Does U.S. Bankruptcy Code § 524(e) apply (discharge of debt of debtor does not affect liability of any other entity on such debt)?

Is the Beneficiary landlord’s capped claim against the Applicant reduced by the amount of LC proceeds paid to the Beneficiary landlord?

The speakers bring to bear years of experience dealing with LCs and bankruptcy, including how to avoid traps for the unwary.

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Letters of Credit & Applicant Bankruptcy:

U.S. & Canadian Bankruptcy Provisions and Cases for Beneficiaries, Issuers, Applicants & Others

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—“Why New York Law and Jurisdiction Offer Advantages for International L/C Transactions,” Documentary Credit World (May 2014; co-authored with David Rabinowitz)
—“Model Standby Forms Under ISP98: Comments on Form 4 – Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand,” Documentary Credit World (July 2012)
—“ISP98 Rule 3.12(a): Is It a Trap, or a Warning to an Unwary Beneficiary of a Letter of Credit?” George Mason Journal of International Law (December 2010)
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– Supreme Court Decides Scope of Bankruptcy Code Section 546(e) Safe Harbor (March 13, 2018)
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– Indenture Bars Guarantor’s Defenses Based on Allegations Trustee Failed to Keep Records and Act in Good Faith (March 2015)
– Life After Healthco (March 1999)

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Other:
– Active in the Toronto Network of IWIRC and TMA NOW
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Goals of the Program

We will explore how the bankruptcy of a letter of credit applicant (Applicant) affects the parties to the letter of credit (LC), including:

1. May the beneficiary (Beneficiary) of the LC draw on the LC, and may the issuing bank (Issuer) pay the LC?
2. May Issuer be reimbursed for paying the LC and keep the reimbursement?
3. What if Beneficiary fails to draw on the LC?

We will examine each issue, first, under U.S. bankruptcy law and, second, under Canadian bankruptcy law.
Simple Letter of Credit Triangle

LC “Independent” of the Reimbursement Agreement and the Underlying Transaction

Issuer

Reimbursement Agreement

Applicant (Debtor, e.g., buyer or borrower)

Beneficiary (e.g., seller or lender)

Underlying Transaction
Putting LCs in Context

• Prior to honor, LC is an “independent” obligation of Issuer to Beneficiary, not a secondary or suretyship obligation.

• LC prior to honor, and LC proceeds after honor, may serve similar purposes as ordinary guaranties, insurance, swaps, escrows, and security interests in Applicant’s (Debtor’s) or a third-party’s property.

• LC prior to honor, and LC proceeds after honor, may resemble collateral indirectly provided by Applicant (Debtor) to Beneficiary via Issuer.

• After honor, Issuer may have certain rights analogous to those of a guarantor or insurer that pays a guaranty or insurance policy. U.C.C. § 5-117 (subrogation).
Supremacy of U.S. Federal Bankruptcy Law Over Certain Conflicting State Laws

• The U.S. Bankruptcy Code is Federal law. It does not have special rules for letters of credit. LCs are mentioned only in § 101(49)(B)(i) (not a "security") and § 366 (LC as "assurance of payment"). Primary goals of the Bankruptcy Code are equal treatment of similarly situated creditors and rehabilitation of the Debtor.

• Overrides conflicting state laws such as portions of U.C.C. Article 5 on LCs (e.g., Applicant’s statutory obligation under U.C.C. § 5-108(i)(1) to fully reimburse Issuer for paying a complying drawing).
Canadian Insolvency Law

- Insolvency law in Canada is also federal law
- Two significant statutes are relevant for this discussion
  - Other statutes apply to specific types of companies or may facilitate other types of restructurings
- Companies’ Creditors Arrangement Act
- Bankruptcy and Insolvency Act
Canadian Insolvency Law (cont’d)

• The *Companies’ Creditors Arrangement Act* specifically addresses letters of credit:

**Persons obligated under letter of credit or guarantee**

11.04 No order made under section 11.02 has affect on any action, suit or proceeding against a person, other than the company in respect of whom the order is made, who is obligated under a letter of credit or guarantee in relation to the company.

• The Bankruptcy and Insolvency Act does not have an analogous provision, but see *Tri-State Signature Homes Ltd, Re*, 2017 ABQB 587.
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

- Who is obligated under the LC?
- Whose property is the LC?
- Automatic stay - Any effect on right to draw generally, particular drawing conditions, or obligation to pay?
- Equitable powers of Bankruptcy Courts.
- *Ipso facto* clauses.
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Who is obligated under the LC?
  • Issuer is obligated to pay Beneficiary if Beneficiary’s presentation complies with the terms and conditions of the LC. LC laws and practice rules require that the documents presented for payment appear on their face strictly to comply with the LC.
  • Issuer pays with its “own funds.” ISP98 Rule 1.10(a)(iv).
  • Debtor is obligated to reimburse Issuer for proper payment by Issuer. Debtor’s reimbursement obligation may arise under a reimbursement agreement, by statute (U.C.C. § 5-108(i)(1)), at common law, and/or under equitable principles. Debtor is not obligated under the LC itself.
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Whose property is the LC?
  • Bankruptcy Code § 541 specifies the property of Debtor’s estate.
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Whose property is the LC?
  • *But see* the much criticized case of *Twist Cap, Inc. v. Se. Bank (In re Twist Cap, Inc.*), 1 B.R. 284, 286 (Bankr. M.D. Fla. 1979) (court enjoined payment of LCs as voidable preferences even though LCs were issued by Issuer prior to preference period).
  • Because the proceeds of an LC are not property of the debtor’s estate, until Beneficiary receives full payment of the amount by the Debtor/Applicant, proceeds from drawing on LCs will not reduce its claim against the Debtor. *In re Stone & Webster, Inc.*, 547 B.R. 588, 607 (Bankr. D. Del. 2016).
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Automatic stay - Any affect on right to draw generally, particular drawing conditions, or obligation to pay?
  • § 362(a) automatically stays, with certain exceptions, various acts against Debtor or its property.
  • Many cases hold automatic stay does not apply to draws on LCs. E.g., *Int’l Fin. Corp. v. Kaiser Group Int’l Inc. (In re: Kaiser Group Int’l Inc.),* 399 F.3d 558, 566 (3d Cir. 2005).
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Automatic stay - Any affect on right to draw generally, particular drawing conditions, or obligation to pay?
  • Avoid drawing conditions that require Debtor to take action, or require Beneficiary or third parties to take action against Debtor or Debtor’s property. Ideally, also avoid drawing conditions requiring notice to Debtor.
  • *Shanri Holdings Corp. v. Kmart Corp. (In re Kmart Corp.),* 297 B.R. 525, 530 (N.D. Ill. 2003) (LC required presentation of Debtor-signed drawing document; after this remand, Bankruptcy Court ordered Debtor to sign document since effect on estate would be *de minimis*).
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Automatic stay - Any affect on right to draw generally, particular drawing conditions, or obligation to pay?
  • *New England Dairies, Inc. v. Dairy Mart Conv. Stores, Inc. (In re Dairy Mart Conv. Store)*, 351 F.3d 86, 88-92 (2d Cir. 2003) (Debtor’s promise to extend or replace LC dischargeable; LC failed to permit drawing for LC expiration or bankruptcy; Beneficiary of LC not a secured creditor and therefore not entitled to adequate protection).
  • *In re Factory Sales & Engineering, Inc., (Factory Sales & Engineering, Inc. v. Electrica Nueva Energia S.A. and JPMorgan Chase Bank, N.A.)*, 2017 WL 4570813, 64 BCD 211 (Bankr. E.D. La. 2017) (fraud under UCC § 5-109 to submit a drawing statement stating that a contract had been terminated when the automatic stay prohibited termination).
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

- Equitable powers of Bankruptcy Courts.
  - “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code.]” § 105(a).
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• Equitable powers of Bankruptcy Courts.
  • In *Wysko*, the injunction allowed Debtor to substitute a certificate of deposit for an LC. That harmed Beneficiary because realizing upon the CD would violate the automatic stay, defeating a purpose of the LC to permit Beneficiary to quickly obtain cash.
  • In *Del. River Stevedores*, Debtor failed to make worker’s compensation payments, and court enjoined Beneficiary from drawing and obtaining the prompt payment it sought.
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

• *Ipso facto* clauses.
  • Does drawing on an LC because of Debtor’s bankruptcy violate the Bankruptcy Code’s prohibition on termination or modification of an executory contract based solely upon Debtor’s bankruptcy filing or insolvency? § 365(e)(1).
May Beneficiary Draw on the LC, and May Issuer Pay the LC?

- *Ipso facto* clauses.
  - What if LC drawing certificate requires Beneficiary to certify that a bankruptcy event has occurred with respect to Debtor?
  - What if LC drawing certificate requires Beneficiary to certify that an “Event of Default” as defined in a specified document has occurred, and the relevant default is a bankruptcy event with respect to Debtor?
  - *In re Metrobility Optical Sys. Inc.*, 268 B.R. 326, 329 (Bankr. D. N.H. 2001) (Beneficiary enjoined from certifying that Debtor had defaulted on lease where there was no default under lease other than Debtor’s bankruptcy filing; certification would be false because § 365(e) prevented lease termination).
May Beneficiary Draw on the LC, and May Issuer Pay the LC? (Canadian Perspective)

• In Canada, it is well established that an LC is an independent obligation.
• Where the Beneficiary satisfies the conditions contained in the LC (e.g. the presentation of the appropriate documents), the issuer bank is obliged to pay the Beneficiary.
• Where the debtor is the beneficiary, a trustee has no greater rights in the LC than the bankrupt had prior to filing.
• In *Re New Home Warranty of British Columbia, 2004 BCCA 186*, the Court of Appeal concluded that where a standby LC, the purpose of which is security, is issued for the benefit for the corporation, the trustee in bankruptcy will have no greater rights than the bankrupt itself had, and thus will not be permitted to draw on the LC for the benefit of the creditors until default had occurred.
May Beneficiary Draw on the LC, and May Issuer Pay the LC? (Canadian Perspective)

• Automatic Stay Issues –
  • In a CCAA proceeding, there is no automatic stay, only the stay granted by the Court pursuant to section 11.02
    • The stay is defined by court order and generally very broad
    • Section 11.04 of the CCAA specifically prohibits the stay of a guarantee or LC
  • Section 11 is broad. Is there any potential flexibility?
  • Under the BIA, there is an automatic stay and no equivalent of 11.04
    • 69.1(1) (a) no creditor has any remedy against the insolvent person or the insolvent person's property, or shall commence or continue any action, execution or other proceeding for the recovery of a claim provable in bankruptcy until the trustee has been discharged or the insolvent person becomes bankrupt
May Beneficiary Draw on the LC, and May Issuer Pay the LC? (Canadian Perspective)

*Tri-State Signature Homes Ltd, Re* clarified that calling on an LC was not stayed by the BIA

- In my view, [creditor's] demand for payment under the letters of credit, if it is a proceeding at all, is a proceeding for the recovery of an obligation owed to it by [lender]. It is not a proceeding taken against [insolvent debtor] or its assets. It is not properly characterized as a "proceeding for the recovery of a claim provable in bankruptcy".
May Beneficiary Draw on the LC, and May Issuer Pay the LC? (Canadian Perspective)

• Automatic Stay Issues
  • What about LCs in a recognition proceeding? Would the foreign treatment of LCs be recognized?
    • No case law directly on point, but courts have made orders in recognition proceedings that would not be made in plenary proceedings
      • Re Xinergy Ltd., 2015 ONSC 2692

• *Ipso Facto* Clauses
  • Both the BIA (section 65.1, 66.34, and 84.2) and the CCAA (section 34) have similar provisions regarding the impact of *ipso facto* clauses
  • An LC is a contract with a third party
    • Is there any impact on the debtor company?
May Beneficiary Draw on the LC, and May Issuer Pay the LC? (Canadian Perspective)

• DIP Financing
  • Section 11.2 (1) On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, a court may make an order declaring that all or part of the company’s property is subject to a security or charge — in an amount that the court considers appropriate — in favour of a person specified in the order who agrees to lend to the company an amount approved by the court as being required by the company, having regard to its cash-flow statement. The security or charge may not secure an obligation that exists before the order is made.
  • What if the pre-filing lender is the DIP lender, can the existing LC’s have the benefit of the DIP charge?
May Beneficiary Keep the LC Proceeds?

• Breach of U.C.C. Article 5 warranty; breach of underlying contract; penalty; windfall; whose claim is it?
• Preferences, direct and indirect.
• Cap on claims for lease damages.
• Other caps and disallowed claims.
• Fraudulent transfers.
May Beneficiary Keep the LC Proceeds?

• Breach of U.C.C. Article 5 warranty; breach of underlying contract; penalty; windfall; whose claim is it?
  • Beneficiary may have to account for its use of the LC proceeds under a number of theories.
  • Potential claimants include (i) the bankruptcy estate and (ii) an unreimbursed Issuer (who may have an assignment of Debtor’s rights, be subrogated to Debtor’s rights, or have other rights to the proceeds).
  • Structured financing may require a party such as Issuer to agree to look solely to its reimbursement claim against Debtor and any collateral, and to waive any right to commence a bankruptcy proceeding against Debtor.
May Beneficiary Keep the LC Proceeds?

• Homemaker Indus., Inc. v. Official Comm. of Unsecured Creditors of HMKR, Inc., No. 03 Civ. 9303, 2004 WL 838168, at *2 (S.D.N.Y. Apr. 20, 2004) (agreement between Debtor and Beneficiary provided that Debtor’s “sole right with respect to the Proceeds shall be an unsecured contractual right … to have the issuer of the [LC] receive for the account of Debtor” any excess proceeds after final settlement).

• PNC Bank v. Spring Ford Indus., Inc. (In re Spring Ford Indus., Inc.), 338 B.R. 255, 262-65 (Bankr. E.D. 2006) (excess proceeds from draw on LC governed by express agreement between Applicant and Issuer pursuant to which proceeds were property of Applicant’s bankruptcy estate; Issuer was an unsecured creditor of Applicant and had no direct claim to LC proceeds).

• But see In re Mirant, No. 03-46590-DML-11, 2005 WL 2589162, at *4-5 (Bankr. N.D. Tex. July 21, 2005) (where Beneficiary retained LC proceeds as collateral for Applicant’s obligations, court denied Issuer’s assertion of reversionary interest in LC proceeds; held Beneficiary is entitled to retain LC proceeds against Issuer where no agreement required return of excess LC proceeds).
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect.
  • Bankruptcy Code § 547(b) makes avoidable:
    • Any transfer of an interest of the debtor in property –
      • to or for the benefit of a creditor;
      • for or on account of an antecedent debt owed by the debtor before such transfer was made;
      • made while the debtor was insolvent;
      • made on or within 90 days before the date of filing of the [bankruptcy] petition; or
      • between 90 days and one year before the date of the filing of the [bankruptcy] petition, if such creditor at the time of such transfer was an insider; and
    • that enables such creditor to receive more than such creditor would receive if –
      • the case were a case under chapter 7 of this title;
      • the transfer had not been made; and
      • such creditor received payment of such debt to the extent provided by the provisions of this title. (Emphasis added; italicized terms defined in Code).
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect.
  • Exceptions: § 547(c) lists 9 exceptions, including:
    • To the extent such transfer was intended to be and in fact a substantially contemporaneous exchange for new value given to the Debtor. Note: the exception does not specify that the specific defendant give the new value to the Debtor.
    • To the extent such transfer was in payment of debt incurred in the ordinary course of business and was made in the ordinary course or according to ordinary business terms.
    • To the extent such transfer creates a security interest that secures certain new value.
May Beneficiary Keep the LC Proceeds?

- Preferences, direct and indirect.
  - Bankruptcy Code § 550
    - Subsection (a) permits the bankruptcy trustee to recover, to the extent that a transfer is avoided under § 547 or certain other sections, “the property transferred, or, if the court so orders, the value of such property, from –
      - “(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
      - “(2) any immediate or mediate transferee of such initial transferee.”
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect.
  • Bankruptcy Code § 550(b) provides that the trustee may not recover under section (a)(2) of this section from –
    • “(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
    • “(2) any immediate or mediate good faith transferee of such transferee.”
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect.
  • *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586 (5th Cir. 1987), *modified*, 835 F.2d 584, 591-95 (5th Cir. 1988) (LC issued just prior to bankruptcy to support unsecured antecedent debt of Debtor to Beneficiary where Issuer had long ago perfected a security interest in Debtor’s assets to secure future advances; court viewed Beneficiary as an indirect transferee of that security interest transferred by Debtor to Issuer and, arguably, in effect transferred to Beneficiary when Issuer issued LC; Beneficiary indirectly benefited from the security interest that induced Issuer to issue the LC; indirect preference may be recovered from Beneficiary). Would it matter whether the LC was issued at Issuer’s discretion during the preference period or pursuant to a pre-preference period commitment?
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect.
  • *Am. Bank v. Leasing Servs. Corp. (In re Air Conditioning, Inc. of Stuart)*, 845 F.2d 293, 298 (11th Cir. 1988) (Debtor granted security interest to Issuer contemporaneously with issuance of LC to support unsecured or undersecured antecedent debt of Debtor to Beneficiary; although security interest was transferred to Issuer, court viewed transfer as for the benefit of Beneficiary who did not have a § 547(c)(1) contemporaneous exchange defense and, therefore, was liable for the value of the security interest).
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect.
  • *Comm. of Unsecured Creditors v. N. Life Ins. Co. (In re Baja Boats, Inc.)*, 203 B.R. 71, 74-75 (Bankr. N.D. Ohio 1996) (payment of LC issued prior to preference period not preferential to Beneficiary; because Issuer was already obligated to Beneficiary under LC, the transfers of collateral to Issuer conferred no benefit on Beneficiary).
  • Direct draw or direct pay LCs *versus* standby LCs or default drawing LCs.
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect
  • Preference “clawbacks”. Permit LC drawing if Beneficiary was paid by Debtor during applicable preference period – without waiting to see if a preference recovery action is commenced. Exchange the initial payment from Debtor for “preference-proof” funds from Issuer. Return Debtor’s payment to Debtor’s estate (or with court’s permission to unreimbursed Issuer). Be sure term of LC runs past the preference period plus a cushion. Be sure drawing conditions work for all types of drawings, e.g. (i) payment default, (ii) non-extension of evergreen LC, (iii) payment during preference period, and/or (iv) other defaults (not resulting in acceleration and non-payment).

• What about payment of LC pursuant to an amendment to LC or a waiver of discrepancies during the preference period? Is that like a direct payment by Debtor to Beneficiary?
May Beneficiary Keep the LC Proceeds?

• Preferences, direct and indirect
  • Rating agency requirements to replace an LC supporting outstanding antecedent debt such as bonds or commercial paper.
  • Ways to protect Beneficiary from preference risk where Issuer of existing LC is unsecured or undersecured and Issuer of replacement LC wishes to be secured.
  • For a time after the Twist Cap decision, it was common for Debtor to give Beneficiary a security interest in the same collateral given to Issuer.
May Beneficiary Keep the LC Proceeds?

- **Practice Alert**: *Pirinate Consulting Grp. V. Styron LLC (In re Newpage Corp.),* No. 11-12804(KG), 2014 WL 4948421 (Bankr. D. Del. Oct. 1, 2014), illustrates that, just because Beneficiary may be correct that there should be no preference exposure, its preference litigation risk cannot be eliminated.

- The Newpage Trustee sought to recover alleged preferences, contending that because Beneficiary drew on a collateralized LC to pay invoices, Beneficiary was not entitled to an “unpaid new value” credit because it did not enrich the bankruptcy estate. Beneficiary argued that it was entitled to use, as part of its new value defense, all the unpaid invoices as of the petition date that were paid post-petition when Beneficiary drew on the LC issued by a non-debtor bank.

- The Bankruptcy Court denied Beneficiary’s and Newpage Trustee’s motion for partial summary judgment, finding issues of fact. First, it was unclear to the Court whether Beneficiary imposed new payment terms during the preference period. Second, because the obligation to reimburse the LC issuer was secured, the draws effectively diminished the estate, and the Court wondered whether Beneficiary was obligated to first seek Court approval for the post-petition draws in order to assert a new value defense. Finally, even though Beneficiary stipulated that the LC reimbursement obligation was secured, the Court found that was an outstanding issue of fact. The case settled before trial.
May Beneficiary Keep the LC Proceeds?

• Cap on claims for lease damages.
  • Bankruptcy Code § 502(b)(6) provides for disallowance of “the claim of a lessor for damages resulting from the termination of a lease of real property” to the extent such claim exceeds a formula.
• Is LC payment by Issuer to Beneficiary subject to recovery for exceeding the cap where Debtor is the tenant and LC applicant? Where bankrupt tenant’s reimbursement obligation to Issuer is fully secured and exceeds the cap, should LC proceeds be treated as if paid by tenant as damages for breach of lease? Or are LC proceeds more like an independent payment from a third party, especially if characterized as supporting obligations rather than rent or damages for termination of lease? Does Bankruptcy Code § 524(e) apply (discharge of debt of Debtor does not affect liability of any other entity on such debt)? Is landlord’s capped claim against Debtor reduced by LC proceeds paid to landlord?
May Beneficiary Keep the LC Proceeds?

• Cap on claims for lease damages.
  • *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003) (LC proceeds treated like cash from tenant security deposit for purposes of calculating amount landlord entitled to retain).
  • *Two Trees v. Builders Transp., Inc. (In re Builders Transp., Inc.)*, 471 F.3d 1178, 1192-93 (11th Cir. 2006) (tenant filed for bankruptcy and assignee of landlord drew on LC; landlord and assignee were obligated to return to the estate all LC proceeds in excess of damages incurred under the lease and calculated under § 502(b)(b); once LC has been paid, underlying contracts determine rights to keep LC proceeds).
  • *EOP-Colonnade of Dallas L.P. v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 271 (5th Cir. 2005) (cap not implicated where landlord did not file a claim).
May Beneficiary Keep the LC Proceeds?

• Other caps and disallowed claims.
• Fraudulent transfers.
May Beneficiary Keep the LC Proceeds? (Canadian Perspective)

• **Caps on Damages**
  - The CCAA does not set a formula for determination of claims
  - The BIA, in some circumstances, does limit claims as determined by a formula
  - Case law goes both ways on this issue
    - *West Shore Ventures Ltd. v. K.P.N. Holding Ltd.*, 25 C.B.R. (4th) 139, 2001 BCCA 279 (holding that the landlord’s claim against the LC is subject to the statutory cap)
    - *Lava Systems Inc. (Receiver & Manager of) v. Clarica Life Insurance Co.* (2002), 2002 CarswellOnt 2053, 27 B.L.R. (3d) 19, 161 O.A.C. 53 (Ont. C.A.) (holding that the funds were property of the bank, not the debtor and thus not subject to the statutory cap)

• **Setoff**
  - Section 21 of the CCAA permits set off in the CCAA
  - Section 97(3) of the BIA also permits set off
    - *Arrangement relatif à Métaux Kitco inc.* 2017 QCCA 268 questions the breadth of set off permitted and suggests we should adopt a pre v post filing distinction more like the US
May Issuer be Reimbursed and Keep the Reimbursement?

• Automatic stay.
• Preferences, direct and indirect.
• Setoffs.
• Cap on claims for lease damages.
• Other caps and disallowed claims.
• Fraudulent transfers.
• Subrogation and other alternatives to reimbursement.
May Issuer be Reimbursed and Keep the Reimbursement?

• Automatic stay.
  • For purposes of the stay, once Issuer pays the LC and Issuer’s reimbursement claim matures, is it different than a lender’s claim for repayment of a loan?
  • Can Debtor be forced or deemed to borrow a loan to reimburse Issuer?
May Issuer be Reimbursed and Keep the Reimbursement?

• Preferences, direct and indirect.
  • If Issuer is unsecured and is reimbursed by Debtor during the preference period, that reimbursement may be a preference unless Debtor had secured its underlying obligation to Beneficiary. Contrast if Issuer was secured prior to the preference period.
  • If Issuer issues an LC and later (non-contemporaneously) obtains collateral from Debtor during the preference period, that transfer may be a preference. *Luring v. Miami Citizens Nat’l Bank (In re Val Decker Packing Co.),* 61 B.R. 831, 841-43 (Bankr. S.D. Ohio 1986).
  • Does Issuer of undrawn LC receive a preference when Beneficiary accepts direct payment from Debtor, thereby indirectly releasing Issuer from its LC obligation and benefiting Issuer to the extent Issuer was unsecured or undersecured?
May Issuer be Reimbursed and Keep the Reimbursement?

• Preferences, direct and indirect.
  • Does Issuer receive a voidable security interest where it issues an LC under a secured line to Beneficiary to support antecedent unsecured debt of Debtor to Beneficiary? Is the security interest indirectly transferred to or for the benefit of Beneficiary? See Air Conditioning, 845 F.2d at 298-99; Compton, 831 F.2d at 594-95.

• Who may be liable for a voidable transfer under Bankruptcy Code § 547 and § 550? Note: post-Deprizio amendments to § 547(i) and § 550(c) to protect non-insiders for transfers made 90 days or more prior to bankruptcy.
May Issuer be Reimbursed and Keep the Reimbursement?

• Preferences, direct and indirect.
  • Does Issuer have defenses under § 547(c)(1) and § 550(b)?
    Distinguish “initial transferee” and “entity for whose benefit such
    transfer was made” from “immediate or mediate transferee of such
    initial transferee”.
  • Note: good faith exchange for value is a defense to a transfer
described in § 550(a)(2) but is not a defense to a transfer covered by
§ 550(a)(1), which can be recovered from the “initial transferee” of
such transfer or “the entity for whose benefit” such transfer was
made.
  • Note: trend for Issuers to learn more about Debtor, Beneficiary, and
underlying transaction (e.g., USA Patriot Act, anti-money laundering
requirements, and credit and reputational concerns) may lead to
acquisition of actual or constructive knowledge that disqualifies
Issuer from a “good faith, and without knowledge” defense.
May Issuer be Reimbursed and Keep the Reimbursement?

• Preferences, direct and indirect.
  • *P.A. Bergner & Co. v. Bank One (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1119-22 (7th Cir. 1998) (Issuer was an unsecured creditor of Debtor that demanded and received prepayment from Debtor of the amount of two LCs that were being drawn on and paid; that transfer of funds to Issuer is analogous to a voidable transfer of a security interest to a previously unsecured creditor on account of antecedent debt).
  • *Two Oil, Inc. v. Tampinex, Inc. (In re Two Oil, Inc.)*, 58 B.R. 966, 966 (Bankr. S.D. Tex. 1986) (payment by Debtor to Beneficiary outside LC not a preference where Issuer was fully secured by pre-preference period collateral.)
  • Possible avoidance or recovery defenses include contemporaneous exchange, ordinary course payment, new value, earmarking, conduit theory, and substitution of creditors.
May Issuer be Reimbursed and Keep the Reimbursement?

• **Setoffs.**
  • Bankruptcy Code § 553(a).
  • With certain exceptions, the Code “does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before commencement of the case ... against a claim of such creditor against the debtor that arose before the commencement of the case.”
May Issuer be Reimbursed and Keep the Reimbursement?

• **Setoffs.**
  • A key exception is where the debt owed to Debtor by Issuer was incurred by Issuer –
    • “(A) after 90 days before the date of the filing of the petition;”
    • “(B) while the debtor was insolvent; and
    • “(C) for the purpose of obtaining a right of setoff against the debtor [with certain exceptions].”
  • If the setoff in *P.A. Bergner & Co.* fell within this exception, it would not be protected from an avoidance action under another provision of the Bankruptcy Code.
May Issuer be Reimbursed and Keep the Reimbursement?

• Cap on claims for lease damages.
  • *Redback Networks*, 306 B.R. at 305. Concurring opinion by Judge Klein – Issuer is viewed as if it were subrogated to landlord’s capped claim against Debtor for lease damages and not asserting an independent, uncapped reimbursement claim against Debtor. Issuer would lose the benefit of any collateral exceeding the cap.
  • Ideas to protect Issuer from Judge Klein’s view:
    • Do not issue an LC to support a capped obligation.
    • Shift risk to Beneficiary.
    • Have Debtor agree not to directly or indirectly exceed the cap.
    • Obtain guaranty or collateral from a third party that waives any claims against Debtor.
    • Waive Issuer’s right of subrogation and similar rights but not its right to reimbursement from Debtor.
May Issuer be Reimbursed and Keep the Reimbursement?

• Other caps and disallowed claims.
• Fraudulent transfers.
  • *Kendall v. Sorani (In re Richmond Produce Co., Inc.),* 195 B.R. 455, 462 (Bankr. N.D. Cal. 1996). Cash collateral provided to Issuer was recovered from Issuer under § 550(a)(2) where Issuer was immediate (not initial) transferee of avoidable fraudulent transfer from Debtor and unable to establish a § 550(b)(1) defense. LC supported payment of purchase price for leveraged buyout of stock in Debtor.
May Issuer be Reimbursed and Keep the Reimbursement?

- **Subrogation and other alternatives to reimbursement.**
  - *E.g.*, subrogation to secured claims, constructive trust claims, and statutory trust claims.
  - U.C.C. § 5-117 ("to the same extent as if the issuer were a secondary obligor"). *See* Restatement of the Law Third, Suretyship (1995).
  - Bankruptcy Code § 509. U.C.C. Revised Article 5 changed state law on the issues of who “is liable with the debtor on” a claim and who is a “codebtor”.
May Issuer be Reimbursed and Keep the Reimbursement? (Canadian Perspective)

• The BIA addresses preference actions in section 95

95 (1) A transfer of property made, a provision of services made, a charge on property made, a payment made, an obligation incurred or a judicial proceeding taken or suffered by an insolvent person

(a) in favour of a creditor who is dealing at arm’s length with the insolvent person, or a person in trust for that creditor, with a view to giving that creditor a preference over another creditor is void as against — or, in Quebec, may not be set up against — the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy; and
May Issuer be Reimbursed and Keep the Reimbursement? (Canadian Perspective) (cont’d)

• The BIA addresses preference actions in section 95 (b) in favour of a creditor who is not dealing at arm’s length with the insolvent person, or a person in trust for that creditor, that has the effect of giving that creditor a preference over another creditor is void as against — or, in Quebec, may not be set up against — the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the day that is 12 months before the date of the initial bankruptcy event and ending on the date of the bankruptcy.

Marginal note: Preference presumed

(2) If the transfer, charge, payment, obligation or judicial proceeding referred to in paragraph (1)(a) has the effect of giving the creditor a preference, it is, in the absence of evidence to the contrary, presumed to have been made, incurred, taken or suffered with a view to giving the creditor the preference — even if it was made, incurred, taken or suffered, as the case may be, under pressure — and evidence of pressure is not admissible to support the transaction.
What if Beneficiary Fails to Draw?

- Risks to Beneficiary and Issuer from direct payment by Debtor to Beneficiary prior to bankruptcy. Is it the light at the end of the tunnel or the train coming to hit Beneficiary?
- Was Debtor’s obligation to Beneficiary fully secured?
- Was Debtor’s contingent reimbursement obligation to Issuer fully secured?
- Long-term LCs.
What if Beneficiary Fails to Draw?

• Risks to Beneficiary and Issuer from direct payment by Debtor to Beneficiary prior to bankruptcy.
  • “Can an unsecured creditor be better off when the debtor defaults rather than paying off the debt? Yes. Law can be stranger than fiction in the Preference Zone.” Comm. of Unsecured Creditors v. Koch Oil Co. (In re Powerine Oil Co.), 59 F.3d 969, 971 (9th Cir. 1995) (Beneficiary that was paid by Debtor received a preference, but was protected by “new value” exception to the extent, if any, that Issuer’s released reimbursement claim was secured).
  • Gulf Oil Corp. v. Fuel Oil Supply & Terminaling Inc. (In re Fuel Oil Supply & Terminaling, Inc.), 837 F.2d 224, 229-30 (5th Cir. 1988) (Beneficiary who did not draw on LC, where Issuer was secured, indirectly gave “new value” to Debtor by enabling Issuer to release unused collateral previously provided to secure reimbursement obligation).
  • What about payment of LC pursuant to a waiver of discrepancies or because Issuer missed discrepancies? Is that like a direct payment by Debtor to Beneficiary?
What if Beneficiary Fails to Draw?

• Was Debtor’s obligation to Beneficiary fully secured?
  • Would an Issuer typically know or care whether a Beneficiary was fully secured by Debtor collateral?
What if Beneficiary Fails to Draw?

• Was Debtor’s contingent reimbursement obligation to Issuer fully secured?
  • Would a Beneficiary typically know or care whether an Issuer was fully secured by Debtor collateral?
  • When an LC expires or is cancelled, does Issuer’s obligation to return any unused “collateral” to Debtor vary depending upon whether Debtor (i) granted a security interest to Issuer, (ii) “prepaid” the LC reimbursement obligation, (iii) provided Issuer with “cover,” or (iv) “purchased” the LC?
What if Beneficiary Fails to Draw?

- Long-term LCs
  - Where Applicant had provided collateral to Issuer and is in bankruptcy proceedings, will Issuer be required to return any portion of the collateral where the LC has not been, and may never be, drawn upon?
  - There is a dearth of reported authority whether Issuer’s contingent unliquidated secured reimbursement claim is allowed pursuant to Bankruptcy Code § 502(c).
What if Beneficiary Fails to Draw?

• **Long-term LCs**
  
  • Even if Issuer’s claim were estimated at less than the undrawn amount of the LC, § 502(c) is not stated as an avoidance power that permits the Court to compel Issuer to return the “excess” amount of its collateral.
What if Beneficiary Fails to Draw?

• Long-term LCs
  • Where a claim is unsecured, Bankruptcy Courts have wide discretion in estimating contingent or unliquidated claims under § 502(c). See Foster v. Granite Broad. Corp. (In re Granite Broad. Corp.), 385 B.R. 41, 49 (S.D.N.Y. 2008). Consequently, it is difficult to predict the value a court will give to such claims, and it is possible the claim could be valued at zero, which could be disastrous for Issuer if the LC is later drawn upon. See In re Kaplan, 186 B.R. 871, 873 (Bankr. D. N.J. 1995) (estimating the value of mortgagee's claim on guaranty at zero because mortgagor was no longer in default, was not in imminent danger of defaulting on mortgage loan, and mortgagee waived mortgagor's default).
Questions? Comments?

Appendix Follows With Direct and Indirect Preference Scenarios
Direct & Indirect Preference Scenarios

Hypothetical Debtor

Debtor:
Assets of $100

Creditor Claims:

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Claim Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$50</td>
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<tr>
<td>B</td>
<td>$50</td>
</tr>
<tr>
<td>C</td>
<td>$50</td>
</tr>
<tr>
<td>D</td>
<td>$50</td>
</tr>
</tbody>
</table>

Total: $200
**Direct & Indirect Preference Scenarios**

**Pro Rata Distribution in Bankruptcy**

Bankruptcy Recovery = 50% for each creditor.

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Claim</th>
<th>Recovery</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ 50</td>
<td>$ 25</td>
<td>$ 25</td>
</tr>
<tr>
<td>B</td>
<td>$ 50</td>
<td>$ 25</td>
<td>$ 25</td>
</tr>
<tr>
<td>C</td>
<td>$ 50</td>
<td>$ 25</td>
<td>$ 25</td>
</tr>
<tr>
<td>D</td>
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<tr>
<td>Total</td>
<td>$ 200</td>
<td>$ 100</td>
<td>$ 100</td>
</tr>
</tbody>
</table>
Direct & Indirect Preference Scenarios

Adding a Pre-Bankruptcy Preference to Creditor A

- Creditor A paid $50 (100%) pre-bankruptcy.
- Leaves Debtor with assets of $50.
- Bankruptcy Recovery = 33-1/3% for B, C & D.
- Creditor A has been preferred at the expense of Creditors B, C and D.

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Claim</th>
<th>Recovery</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
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<td>$ N/A</td>
<td>$ N/A</td>
</tr>
<tr>
<td>B</td>
<td>$ 50</td>
<td>$ 16.66</td>
<td>$ 33.33</td>
</tr>
<tr>
<td>C</td>
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<tr>
<td>Total</td>
<td>$ 150</td>
<td>$ 50.00</td>
<td>$100.00</td>
</tr>
</tbody>
</table>
Adding an Undrawn LC or Guarantee to Creditor A
And Issuer *Unsecured*

**Debtor:**
Assets of $100

**Issuer**

Contingent Reimbursement Obligation

$50 Contingent Payment Obligation to Creditor A

**Creditor Claims:**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>Total:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-$50</td>
<td>-$50</td>
<td>-$50</td>
<td>-$50</td>
<td>$200</td>
</tr>
</tbody>
</table>

*(Issuer: contingent claim)*
Direct & Indirect Preference Scenarios

LC or Guarantee to Creditor A Paid Where Issuer was *Unsecured*

<table>
<thead>
<tr>
<th>Creditor Claims:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer</td>
</tr>
<tr>
<td>B</td>
</tr>
<tr>
<td>C</td>
</tr>
<tr>
<td>D</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
</tr>
</tbody>
</table>

Debtor:

Assets of $100

Recovery still 50% for B, C & D. Issuer effectively substituted for Creditor A.
Direct & Indirect Preference Scenarios

Undrawn LC or Guarantee to Creditor A
And Issuer Fully *Secured*

Fully Secured
Contingent
Reimbursement Obligation

Issuer

$50 Contingent Payment Obligation to Creditor A

<table>
<thead>
<tr>
<th>Creditor Claims:</th>
</tr>
</thead>
<tbody>
<tr>
<td>A    -</td>
</tr>
<tr>
<td>B    -</td>
</tr>
<tr>
<td>C    -</td>
</tr>
<tr>
<td>D    -</td>
</tr>
<tr>
<td>Total:</td>
</tr>
</tbody>
</table>

(Issuer: contingent claim)

Debtor:
Assets of $100

Letters of Credit and Applicant Bankruptcy
Direct & Indirect Preference Scenarios

LC or Guarantee to Creditor A Paid & Issuer Reimbursed From Collateral Where Issuer Was Fully Secured

Debtor:

Remaining Assets of $50

<table>
<thead>
<tr>
<th>Creditor Claims:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>$50</td>
</tr>
<tr>
<td>C</td>
<td>$50</td>
</tr>
<tr>
<td>D</td>
<td>$50</td>
</tr>
<tr>
<td>Total:</td>
<td>$150</td>
</tr>
</tbody>
</table>

Recovery = 100% for Creditor A & Issuer.
33-1/3% for Creditors B, C, & D.
Looks like the scenario where Creditor A was preferred at the expense of Creditors B, C & D.
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