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From the Bankruptcy Courts: Release of Standby Letter of Credit as a Defense to a Preference Action

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RELEASE OF STANDBY LETTER OF CREDIT AS A DEFENSE TO A PREFERENCE ACTION

The standby letter of credit is a common device used by credit executives to assure that payment of a financial obligation will be forthcoming. However, a recent decision of the Court of Appeals for the Fifth Circuit demonstrates how the benefits of having a standby letter of credit goes well beyond the assurance that payment will be received. In *In re Fuel Oil Supply & Terminaling, Inc.*,[1] the *release* of a standby letter of credit upon prebankruptcy performance of the underlying obligation was subsequently relied on to protect a transfer from attack as a voidable preference under Section 547 of the Bankruptcy Code.

Exchange Agreement

On May 6, 1981, Gulf Oil Corporation (Gulf) and Fuel Oil Supply & Terminaling, Inc. (FOSTI), entered into an exchange agreement (Exchange Agreement) by which Gulf agreed to transfer to FOSTI a total of 200,000 barrels of gasoline in the Colonial Pipeline at Pasadena, Texas, and FOSTI agreed to transfer to Gulf the same quantity of gasoline at a certain time later that year. In addition, FOSTI agreed to pay Gulf a $0.01 per gallon "handling differential" for each thirty-day period on gasoline delivered by Gulf. This type of exchange transaction is a mechanism that is commonly used by oil companies to increase efficiency and minimize transportation costs when each oil company owns crude oil and operates refineries located in different places. The exchange enables each company to obtain crude oil at a location that is closer to its own refinery.

The Exchange Agreement also required FOSTI to provide Gulf with a letter of credit on the outstanding balances. FOSTI procured a standby letter of credit from each of two banks which named Gulf as beneficiary and

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[1] 837 F.2d 224 (5th Cir. 1988).

which fully secured FOSTI's obligations to Gulf. FOSTI gave the banks security interests in collateral which was, at all times, equal to or in excess of the face value of the letters of credit. Describing the way in which a letter of credit operates, the court stated: "Under a standby letter of credit, the bank becomes primarily liable to the beneficiary upon the default of the bank's customer to pay for the goods or services. . . . The shifting of liability to the bank rather than to the services or goods provider is the main purpose of the letter of credit."[2]

The performance of the terms of the Exchange Agreement with slight alterations of time and location commenced with Gulf delivering approximately 200,000 barrels of gasoline to FOSTI in May and June of 1981. FOSTI paid Gulf a sum of money as a "place and term differential." In July and August of the same year, FOSTI performed its end of the bargain by delivering approximately 200,000 barrels of gasoline to Gulf and by sending Gulf a check for the "handling differential." Since FOSTI fully performed the agreement, on August 4 Gulf cancelled one of the letters of credit and the other one expired on August 31.

Bankruptcy Case Filed

On September 4, 1981, an involuntary petition under chapter 7 of the Bankruptcy Code was filed against FOSTI and the case was converted to chapter 11 one month later. As debtor in possession, FOSTI commenced an action against Gulf to recover the value of the gasoline that FOSTI delivered to Gulf plus the differential charges paid to Gulf, alleging that these transfers were voidable preferences under Section 547 of the Code. In turn, Gulf filed a third-party complaint against the banks seeking reinstatement of the letters of credit and indemnity.

Bailment Not Sale

All parties moved for summary judgment. The bankruptcy court granted the banks' and FOSTI's motions and denied Gulf's motion. The district court affirmed insofar as it pertained to the banks but vacated the bankruptcy court's judgment as it pertained to FOSTI. The district court held that with respect to the gasoline transfers, the Exchange Agreement created a bailment, not a sale, and, accordingly, there was no antecedent debt under Section 547(b)(2). In essence, the district court reasoned that no debt is created by a bailment. The district court, in analyzing the differential payments, held that the release of

[2] *Id.* at 225 n.2 (quoting *In re* Compton Corp., 831 F.2d 586, 590 (5th Cir. 1987)).

the letters of credit by Gulf did not provide FOSTI with "new value" to constitute a defense under Section 547(c)(1).

The court of appeals declined to resolve the question whether the exchange transaction was a bailment; regardless of whether the elements of a preference set forth in Section 547(b) are present, "we find that the elements of section 547(c)(1) are satisfied by the tripartite relationship between FOSTI, Gulf and the Banks."[3]

Purposes of Act Met

The court stated that the purpose of Section 547 was to serve two congressional goals. "First, by bringing back into the debtor's estate certain transfers made shortly before the filing of the bankruptcy petition, it creates a disincentive for creditors to attack a financially unstable debtor. Second, it promotes equality among unsecured creditors by forcing these creditors to share the debtor's unencumbered assets on a pro rata basis."[4] The court emphasized, however, that "these concerns apply to a lesser degree to creditors with fully secured claims."[5]

Section 547(c) exempts from the trustee's avoidance power certain preferential transfers that do not further the twin goals of Section 547. Section 547(c)(1) provides:

> The trustee may not avoid under this section a transfer—
> (1) to the extent that such transfer was
> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
> (B) in fact a substantially contemporaneous exchange.

The term "new value" is defined in Section 547(a)(2) to include the "release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law. . . ." As an illustration, the court described a situation in which a creditor takes a perfected security interest in the debtor's collateral and, within ninety days prior to bankruptcy, releases that security interest upon the debtor's performance of its obligation. "This outcome is consistent with the principle underlying § 547(c)(1) because the release of the debtor's collateral offsets the transfer to the creditor, thereby resulting in no depletion to the debtor's estate."[6]

Instead of taking a security interest in FOSTI's assets, Gulf

[3] *Id.* at 227.
[4] *Id.*
[5] *Id.*
[6] *Id.* at 228.

was named as beneficiary on the two letters of credit issued by the banks. The banks held the security interests in FOSTI's assets, not Gulf. When FOSTI transferred gasoline and money to Gulf, Gulf did not release any collateral owned by FOSTI and, FOSTI argued, Gulf gave no new value. The releases of the collateral were by the banks, not by Gulf. Nonetheless, Gulf contended that the requirements of Section 547(c)(1) were met by the "tripartite relationship." That is, in response to FOSTI's performance, Gulf released the letters of credit and the banks released FOSTI's collateral, thereby providing FOSTI with new value. FOSTI did not dispute Gulf's contention that the exchange was contemporaneous and that the parties intended that the performance by FOSTI would result in the banks' contemporaneous release of the collateral. FOSTI relied on the argument that the requirements of Section 547(c)(1) were not satisfied because the banks, not Gulf, gave new value to FOSTI.

Independence Principle

The district court held that when there is a letter of credit, the relationship between the issuing bank and its customer (the debtor) and the relationship between the bank and the receiver of the letter of credit (the creditor) are legally irrelevant to the analysis of the relationship between the debtor and the creditor. The district court based its holding on the proposition set forth in *In re Originala Petroleum Corp.*[7] that letters of credit involve three separate and independent relationships. The district court concluded, therefore, that new value must be given directly to the debtor (FOSTI) by the creditor who received the prepetition transfer (Gulf) in order for Section 547(c)(1) to apply.

Risk Allocation

The court of appeals disagreed with the district court's reliance on the principle set forth in *Originala.* Although the arrangement between the banks, the debtor and the creditor were substantially the same, in *Originala* the debtor failed to perform its obligation prior to bankruptcy and the issue was whether the creditor could be enjoined from drawing on the letter of credit. The court in *Originala* noted that letters of credit serve to shift the risk of nonperformance to the banks and, therefore, it refused to issue an injunction because to do so would upset that risk allocation:

> The independence principle preserves the allocation of risk to the issuing bank by requiring the issu-

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[7] 39 Bankr. 1003 (Bankr. N.D. Tex. 1984).

> ing bank to honor a draw request notwithstanding a dispute between the customer and the beneficiary as to an alleged breach of the underlying contract. Letter of credit financing will cease to be a viable component of finance world-wide unless the independence principle [is] preserved.[8]

The court of appeals in *Fuel Oil Supply* distinguished *Originala* by noting that FOSTI did not seek to prevent Gulf from drawing on the letters of credit, but instead was seeking to recover transfers it made to Gulf for which it received new value in the form of released collateral. "On these facts, the independence principle would not be compromised by a ruling in favor of Gulf because FOSTI's pre-bankruptcy performance effectively absolved the Banks of liability."[9]

Purposes of Legislation

Returning to the congressional purposes underlying Section 547(c)(1), the court of appeals observed that the letters of credit assured Gulf full payment upon FOSTI's failure to perform, and the collateral backing the letters of credit secured the bank. Since both were fully protected, neither had significant incentive to unfairly force FOSTI to perform. Assuming that FOSTI had not performed, upon filing the bankruptcy petition Gulf would have drawn on the letters of credit and the banks would have been entitled to the collateral. "Therefore, permitting FOSTI to recover the value of its transfers to Gulf would serve neither of the goals which animate the preference section. . . . The exchange did not result in a depletion of FOSTI's estate, and therefore FOSTI's unsecured creditors were not impaired by this transaction."[10]

Focusing on the banks' right to the collateral as a disincentive for the banks to unfairly compel FOSTI to perform, the court recognized that the filing of a bankruptcy petition could have an adverse impact on the banks' position. The court stated in a footnote:

> This is not to say that the banks would have been entitled to immediately foreclose on the collateral. While section 362, the automatic stay provision, 11 U.S.C. § 362, would have prevented the Banks from taking immediate action, the Banks, as creditors with fully secured claims, would have eventually received the value of their claims. *Delay in payment is one risk that the Banks assume by issuing letters of credit.* [Emphasis added.][11]

Although the court did not mention other provisions of the Bank-

[8] *Id.* at 1008.
[9] 837 F.2d at 229.
[10] *Id.* at 229-230.
[11] *Id.* at 229 n.14.

ruptcy Code that could further the delay of the banks' realization of the collateral in the event of FOSTI's default, another cause of delay is that the debtor in chapter 11 may continue to use the collateral under Section 363 provided that the banks are adequately protected in accordance with Section 361.

It is interesting to note that the court of appeals *assumed* that the banks' security interests were properly perfected.

> Typically, banks enter arrangements with their business customers whereby the banks provide financing in exchange for a promissory note and a security agreement with a future advances provision. . . . The security agreement is perfected by the filing of a financing statement. . . . There is nothing in the record to indicate that the relationship between the Banks and FOSTI deviated from the typical arrangement.[12]

Perfection of Security Interests Assumed

The assumption that the banks' security interests were perfected is critical to the court's decision. If the security interests were unperfected, they would have been voidable in bankruptcy pursuant to Section 544(a)(1), the so-called strong-arm clause that gives the trustee or debtor in possession the status of a hypothetical judicial lien creditor. In that event, the collateral would have become property of the estate free of any liens. Therefore, the banks' release of unperfected security interests upon FOSTI's prepetition performance would not have had any impact upon the estate and could not have constituted new value. Consistent with this analysis, Section 547(a)(2) provides that "new value" includes the release of property previously transferred to the transferee "in a transaction that is neither void nor voidable by the debtor of the trustee. . . ." Accordingly, if the banks' security interests were not perfected, making them voidable under Section 544(a)(1), the release of the collateral could not constitute "new value" for Section 547(c)(1) purposes.

Conclusion

The decision in *Fuel Oil Supply* does not mean that the existence of a standby letter of credit will always be the basis of a Section 547(c)(1) defense to a preference action. The reasoning of the court of appeals is limited to situations where the letter of credit is secured by an unavoidable perfected security interest that was released upon performance of the underlying obligation. Moreover, if the letter of credit is secured by a lien on the debtor's assets and

[12] *Id.* at 228 n.11.

was issued within the preference period for the purpose of protecting an otherwise unsecured creditor on a preexisting debt, the tripartite transaction may be viewed as preferential and may be avoided.[13]

[13] See *In re* Compton Corp., 831 F.2d 586 (5th Cir. 1987), *op. on reh'g,* 835 F.2d 584 (5th Cir. 1988); see also B. Weintraub & A. Resnick, *Bankruptcy Law Manual* ¶ 7.05[12] (1988 Supp.); Weintraub & Resnick, "Enforceability of Letters of Credit When the Customer Is in Bankruptcy: From *Twist Cap* to *Air Conditioning,*" 20 U.C.C. L.J. 96 (1987).