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From the Bankruptcy Courts: Expiration of Letter of Credit After Payment Leaves Creditor Vulnerable to Preference Risk

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EXPIRATION OF LETTER OF CREDIT AFTER PAYMENT LEAVES CREDITOR VULNERABLE TO PREFERENCE RISK

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.

This is how Circuit Judge Alex Kozinski began his majority opinion for the Court of Appeals in *In re Poweline Oil Company*,[1] in which the Ninth Circuit provided an important lesson for creditor beneficiaries of letters of credit, guarantees, and other third-party surety arrangements: It is risky to rely on a letter of credit if it may expire after direct payment of the underlying debt without providing for recourse against the issuer in the event that the creditor-beneficiary is required to disgorge payment as a voidable preference, especially if the issuer's contingent reimbursement right against the debtor may become less than fully secured. Failure to heed this advice could result in the creditor having to repay at least a portion of the amount received from the debtor as a voidable preference without having the protection against the debtor's insolvency that the letter of credit or guarantee was intended to provide.

The Facts

When Koch Oil Company agreed to sell crude oil to Powerline Oil Company, Koch was named as beneficiary of two irrevocable standby letters of credit issued by First National Bank of Chicago for the purpose of securing Powerline's obligations. The letters of credit, which were due to expire in April 1984, were issued in connection with a $250 million line of credit extended to Powerline by a syndicate consisting of several banks and insurance companies. The line of credit was secured by a security interest on most of Powerline's personal property. First National Bank of Chicago was one of the lenders covered by the security agreement. The $8.7 million aggregate amount of the two letters of credit was at all times sufficient to cover the price of the oil sold to Powerline.

In early 1984, Powerline paid Koch $8.5 million for oil deliveries.

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[1] 59 F3d 969 (9th Cir. 1995).

Unfortunately for Koch, Powerline filed a Chapter 11 petition within ninety days after such payments. Even more unfortunate was that—after the letters of credit had expired by their own terms—the Creditors' Committee initiated a voidable preference action against Koch to recover $3.2 million of the $8.5 million of payments. The reason for seeking the return of $3.2 million was that such payments were made more than the forty-five days after the delivery of oil, which, according to the version of the Bankruptcy Code in effect at that time, took those payments out of the "ordinary course of business" exception to the preference provision.[2]

Bankruptcy Court Protects Koch

In the bankruptcy court, Koch was successful in obtaining summary judgment in its favor based on the so-called "contemporaneous exchange for new value exception" to the voidable preference provision. That is, under Section 547(c)(1) of the Bankruptcy Code, a transfer is not voidable to the extent that it was "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 was "in fact a substantially contemporaneous exchange."[3] Since the voidable preference provision of the Code found in Section 547(b) is generally aimed at avoiding transfers of the debtor's assets on the eve of bankruptcy that unduly benefit one creditor over others, the "contemporaneous exchange for new value exception" recognizes that the policy behind the preference provision does not apply to prebankruptcy transfers that do not result in a depletion of the debtor's estate.

Courts have held that the "contemporaneous exchange for new value exception" applies when payment to a fully secured lender in satisfaction of an antecedent debt results in a release of the lien on the debtor's property. In essence, if a $10 million debt is paid that results in the removal of a $10 million lien on the debtor's assets, such payment has no adverse impact on the value of the debtor's estate and the corresponding distribution to unsecured creditors in the event of the debtor's liquidation. This principle also has been applied where the creditor is itself unsecured, but is the beneficiary of a letter of credit or guarantee and the letter of credit issuer or guarantor has a reimbursement right against the debtor that is secured by a lien on the debtor's assets. For example, in *In re Fuel Oil Supply & Terminaling, Inc.*,[4] the debtor paid an unsecured creditor within the

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[2] See 11 USC § 547(c)(2), which contains the "ordinary course of business" exception to the preference provision of the Bankruptcy Code. Prior to a 1984 amendment to § 547(c)(2), the exception applied only if the preferential payment was made within forty-five days after the date on which the debt was incurred. The forty-five day limitation was removed in 1984.

[3] 11 USC § 547(c)(1).

[4] 837 F2d 224 (5th Cir. 1988).

ninety-day preference period. However, since the creditor was the beneficiary of letters of credit issued by banks that had security interests in the debtor's property that exceeded the amount of the debtor's obligations to the unsecured creditor, and the result of the debtor's direct payment to the unsecured creditor was the release of the bank's lien on the debtor's property, the Court of Appeals for the Fifth Circuit held that the payment was a contemporaneous exchange for new value protected under Section 547(c)(1). "[T]he release of the debtor's collateral offsets the transfer to the creditor, thereby resulting in no depletion to the debtor's estate."[5]

Based on this reasoning, the bankruptcy court agreed with Koch that the exception for contemporaneous exchanges under Section 547(c)(1) was applicable to the $3.2 million payment made by Powerline, which had the simultaneous effect of releasing the bank's lien on Powerline's personal property.

Appeal to the BAP

The bankruptcy appellate panel affirmed the bankruptcy court's summary judgment, but on a different ground. The BAP reasoned that the $3.2 million payments did not satisfy one of the elements of a preference spelled out in Section 547(b)(5) of the Code. That element requires that, to be a voidable preference, the subject transfer must enable the creditor to receive "more than such creditor would receive if—(A) the case were a case under chapter 7 of [the Bankruptcy Code]; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."[6] The BAP concluded that, even if the $3.2 million payment had not been made, it would have been paid in full by drawing on the letters of creditor.

The BAP itself appeared to have recognized that a literal or traditional application of Section 547(b)(5) may not have saved Koch from the preference attack. Courts have applied that subsection by measuring what the creditor received as a prebankruptcy payment against what the creditor would have received *from the bankruptcy estate* if the payment had not been made and the debtor had filed a Chapter 7 petition. For example, if in a hypothetical Chapter 7 case, the creditor would receive a distribution from the debtor's estate of only 50 percent of its claim, the full payment of the claim during the ninety-day preference period enables the creditor to receive more than it would have received under the provisions of the Code—regardless of whether the creditor has a right to receive additional payment from a third party. The fact that a debt is guaranteed by a solvent third party is irrelevant in determining whether the preferential payment enabled the creditor to receive more than it would have

[5] 837 F2d at 228.

[6] 11 USC § 547(b)(5).

received *from the debtor's Chapter 7 estate.* As the Fourth Circuit wrote in *In re Virginia-Carolina Financial Corp.*, the relevant inquiry under Section 547(b)(5) focuses "not on whether a creditor may have recovered all of the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than 100% payout" from the debtor's estate.[7]

Although the fact that Koch had recourse against First National Bank on the letters of credit at the time it received payment from Powerline should have been irrelevant in determining whether the $3.2 million payment was voidable as a preference, the BAP—based on a rule of reason designed to avoid an inequitable result—carved out a new exception to the general rule that recourse against third parties has no bearing on the application of Section 547(b)(5). The BAP held that the presence of a letter of credit *could* be taken into account in applying Section 547(b)(5), but only if it expires after the payment was made and before the preference litigation. Otherwise, the application of the Bankruptcy Code would produce the inequitable result of placing Koch in a much worse position merely because Powerline paid its debt rather than having defaulted at a time when Koch could have drawn on the letters of credit.

The BAP wrote that a creditor's rights against a surety "are not relevant to whether a transfer is preferential so long as those rights are still in place after the preference action is commenced. . . . [But] when that right of action against the surety no longer exists, it is incumbent upon the court to measure the net recovery that the transferee would have obtained from the surety had the transfer not been made."[8]

The Ninth Circuit Reverses

The court of appeals found fault with the holdings and reasoning of both the bankruptcy court and the BAP. With respect to the "contemporaneous exchange for new value exception" under Section 547(c)(1), the court of appeals noted that those cases that have recognized that payment to an unsecured creditor is not a voidable preference if it results in the release of a security interest on the debtor's property held by the issuer of a letter of credit, such as the *Fuel Oil Supply & Terminaling* case mentioned previously, involved situations in which the issuer was *fully* secured so that payment to the creditor released collateral of the same value. In contrast, at the time of the $3.2 million payment to Koch, First National Bank's contingent reimbursement claim against Powerline was only *partially* secured. Powerline had $282 million in total secured debt at the time, but the value of the collateral securing that debt was only $66 million. In addition, First

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[7] 954 F2d 193, 199 (4th Cir. 1992).

[8] Quoted by the Court of Appeals, 59 F3d at 972–973.

National did not even have a first lien on those assets above the rights of other lenders because, under the agreement with the syndicate of banks and insurance companies that provided the line of credit, all secured lenders agreed to share equally in the collateral. Therefore, only a portion of First National Bank's contingent reimbursement claim against Powerline was secured by Powerline's assets.

When Powerline made the $3.2 million payment, it had the effect of releasing First National's lien, but only to the extent that the claim was secured. "Thus," the court noted, "Powerline received new value equal to the amount of the secured portion of First National's reimbursement claim."[9] But with respect to the unsecured part of the bank's contingent reimbursement claim, the court stated that "Powerline didn't receive new value; the bank couldn't release a security interest in Poweline's assets it didn't have. . . . The contemporaneous exchange for new value exception therefore doesn't protect Koch's $3.2 million payment to the extent First National's reimbursement claim was unsecured."[10] Because the court of appeals could not determine from the record the amount by which First National Bank's contingent reimbursement claim against Powerline was unsecured, the proceeding was remanded to the bankruptcy court for that determination. To the extent that the bank's reimbursement claim was unsecured, that portion of the $3.2 million payment would not be protected by the contemporaneous exchange for new value exception.

Rejecting the BAP's "Rule of Reason"

The court of appeals also rejected the BAP's application of Section 547(b)(5). The BAP applied that subsection in a manner that protected Koch from the preference attack because, had the $3.2 milion payment not been made, Koch would have been able to draw on the letters of credit that are no longer in existence. Now that the letters of credit had expired, recovering the payment as a preference would leave Koch unprotected. Clearly, the BAP was attempting to achieve a fair and reasonable result, despite the fact that under prevailing case law the availability of a surety, letter of credit, or other third party codebtor is irrelevant when applying Section 547(b)(5). According to the court of appeals, "The BAP cited no authority for this proposition and we construe it to have been an exercise of its equitable powers."[11]

Recognizing that bankruptcy courts "are sometimes referred to as courts of equity,"[12] the court of appeals emphasized the limits of the bankruptcy court's equitable powers. It said:

[9] 59 F3d at 973.

[10] 59 F3d at 973–974.

[11] 59 F3d at 973.

[12] Id.

> Equity may not be invoked to defeat clear statutory language, nor to reach results inconsistent with the statutory scheme established by the Code. . . . Because the statutory language here provides no basis for the BAP's "rule of reason," we conclude that it was error to consider the right to draw on third-party letters of credit in deciding whether Koch had received a preference.[13]

The dissenting judge in *Powerline* did not agree with the majority's reading of Section 547(b)(5) and stated:

> The plain language of the statute does not limit consideration to funds from Powerline's estate. Under a hypothetical chapter 7 liquidation, it could have collected from First National as "provided by the provisions of this title." In its opinion, the BAP ruled that "[n]othing in title 11 would prevent a draw down on the credits here at issue had Powerline filed bankruptcy without paying Koch."
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> In my opinion, the BAP's decision does not avoid the plain language of section 547(b)(5).[14]

Conclusion

Although it is easy to see how the BAP could sympathize with Koch, the Ninth Circuit's decision is sound—both as a matter of statutory construction and as a policy matter. Because First National Bank's reimbursement obligation was undersecured, the result of the $3.2 million payment to Koch during the preference period was removal of an encumbrance on *less than* $3.2 million worth of Powerline's property. That is, Powerline's payment produced a net reduction in the value of Powerline's estate that was available to unsecured creditors in the bankruptcy case, while giving Koch a 100 percent recovery on its unsecured claim at a time when Powerline was insolvent.

In addition, the payment clearly gave Koch more than it would have received from Powerline's estate if there had been a Chapter 7 liquidation and no prebankruptcy $3.2 million payment. The availability of other sources of payment, such as a third-party guaranty or letter or credit, should not be relevant in determining whether the payment was a preference—whether or not the guaranty or letter of credit had expired. Otherwise, an insolvent debtor would be free to pay favorite unsecured creditors immediately before bankruptcy, thus depriving other unsecured creditors of available assets from which to make a distribution, merely because the favorite creditors had third-party guarantees.

The strange lesson to be learned from *Powerline* is that, as Judge Kozinski has warned, in the Preference Zone an unsecured creditor may be better off when the debtor defaults rather than paying off the debt. In more practical terms, it is risky to rely on a letter of credit—or any other third-party surety ar-

[13] Id.

[14] 59 F3d at 974.

rangement—if the issuer's contingent reimbursement right against the debtor may become less than fully secured and the letter of credit may expire after payment of the underlying debt without providing for recourse against the issuer in the event that the creditor-beneficiary is required to disgorge the payment as a voidable preference.