1987

From the Bankruptcy Courts: Enforceability of Letters of Credit When the Customer is in Bankruptcy: From Twist Cap to Air Conditioning

Benjamin Weintraub

Alan N. Resnick

Maurice A. Deane School of Law at Hofstra University

Follow this and additional works at: https://scholarlycommons.law.hofstra.edu/faculty_scholarship

Recommended Citation
Benjamin Weintraub and Alan N. Resnick, From the Bankruptcy Courts: Enforceability of Letters of Credit When the Customer is in Bankruptcy: From Twist Cap to Air Conditioning, 20 UCC L.J. 96 (1987)
Available at: https://scholarlycommons.law.hofstra.edu/faculty_scholarship/827

This Article is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Hofstra Law Faculty Scholarship by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.
ENFORCEABILITY OF LETTERS 
OF CREDIT WHEN THE 
CUSTOMER IS IN BANKRUPTCY: 
FROM TWIST CAP TO AIR 
CONDITIONING

The Twist Cap case\(^1\) gave the business community a jolt with respect to letters of credit that it had had difficulty in overcoming, until the arrival of the Page\(^2\) and M.J. Sales cases\(^3\) smoothed that disturbance. All was quiet in the realm of letters of credit until the arrival of the Air Conditioning of Stuart case,\(^4\) in which the court canceled a letter of credit as a voidable preference. If the Twist Cap case was easy to unscrew, we find that the Air Conditioning case presented no cause for alarm, particularly in the warm Southern District of Florida. A quotation from a philosopher: "A metaphor is a terrible thing to waste."

**Twist Cap**

Twist Cap, Inc., entered into a security agreement in March 1978 with the Southern Bank to secure letters of credit issued by the bank on behalf of Twist Cap. The bank issued three letters of credit: one for $30,000 issued prior to the security agreement and payable to Alcoa, one for $30,000 issued in June 1978 payable to Alcoa, and one for $25,000 issued in March 1979 payable to Central Can Co. (Central). On August 22, 1979, Twist Cap filed a petition for relief under Chapter XI of the former Bankruptcy Act and, only six days later, Twist Cap as debtor in possession filed a complaint and obtained a temporary restraining order prohibiting the bank from honoring the three letters of credit until a full hearing could be held. Alcoa and Central, which were added as defendants, moved to dismiss the complaint challenging the court’s subject matter jurisdiction. They contended that the letters of credit were not “properties of the debtor” and that the bank-
ruptcy court's jurisdiction was limited under Section 311 of the old Bankruptcy Act to "properties of the debtor."

The debtor's position was that the court's jurisdiction depended on whether the letters outstanding in the hands of third parties were secured by properties of the debtor. The court agreed with the debtor, stating that it "is clear that these letters of credit are in fact secured by properties of the debtor and that if they are honored by the Bank, the Bank will assert that the properties of the debtor included in the collateral previously pledged secured all indebtedness of the debtor owed to the Bank including the sums paid out by the Bank in honoring the letters of credit." Moreover, whether or not Section 311 applied as the basis of jurisdiction was immaterial to the court because of the court's broad injunctive powers under Section 2a(15) of the Act.

Most disturbing to the business community was that the Twist Cap court also justified the issuance of a temporary restraining order by reasoning that "to permit these two unsecured creditors to receive a payment, possibly in full, on the pre-petition indebtedness owed to them by the debtor would amount to an impermissible preferential treatment of these two unsecured creditors which is contrary to the scheme of Chapter XI and would certainly be counterproductive to the debtor's efforts to obtain rehabilitation." Although the court made it clear that "these conclusions should not be construed to be a determination of the debtor's ultimate right to stop payment of these letters of credit" and that the court intended only to preserve the status quo until the hearing on the merits (which was never held because the case was settled), the court's mere suggestion that the letters of credit may be canceled as a voidable preference had a potentially chilling effect on the vitality of letters of credit. This was especially alarming because the letters were issued and the debtor signed a security agreement with the bank before the crucial four-month preference period under the former Act. Even a temporary delay in the ability of a creditor to cash an outstanding letter of credit can erode the business community's confidence in these previously invulnerable devices.

---

5 1 Bankr. at 285.

6 Id.; see former Bankruptcy Act § 60 (voidable preference).
7 Twist Cap, 1 Bankr. at 286.
9 For commentary criticizing the Twist Cap decision, see, e.g., Baird, "Standby Letters of Credit in Bankruptcy," 49 U. Chi. L. Rev. 130 (1982); Chaitman & Sovern, "Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a
Sections 362 and 549 as Applied to Letters of Credit: The Page Case

The disturbance caused by Twist Cap was reduced to some extent when the district court in In re Page\(^10\) rejected new attacks on letters of credit based on Section 362\(^11\) automatic stay provisions and Section 549\(^12\) postpetition transfer restrictions under the Bankruptcy Code.

Westinghouse Credit Corp. (WCC) was a substantial creditor of Page Associates, a limited partnership, and Virginia Page, its sole general partner. In addition to holding a deed of trust on Page Associates' hotel, WCC held a $500,000 letter of credit issued by First National Bank of Maryland. As a condition of issuing the letter of credit to WCC, the bank required Mrs. Page and Page Associates to agree to indemnify the bank in the event that WCC cashed the letter of credit. As security for the indemnification agreement, Page Associates pledged a $100,000 certificate of deposit with the bank and Mrs. Page gave the bank a second deed of trust on her residence which was properly recorded.

Subsequently, Page Associates and Mrs. Page filed chapter 11 petitions in 1981. Only four days later, WCC presented the letter of credit to the bank for payment. The following day, the debtor filed a complaint and motion for a temporary restraining order and preliminary injunction seeking to enjoin the bank's honoring of the letter of credit. The bankruptcy court issued the temporary restraining order and, after a hearing, entered a preliminary injunction precluding WCC from cashing the letter of credit until further order.

The bankruptcy court enjoined payment of the letter of credit on three grounds: (1) payment would be a postpetition transfer in violation of Section 549 of the Code, (2) payment would constitute a transfer of assets in violation of the Section 362 automatic stay, and (3) payment would "severely jeopardize the filing of a successful Plan of Reorganization under chapter 11."\(^13\)

Fortunately for those who regularly rely on letters of credit as a means of doing business, the district court reversed the bankruptcy court's decision and set aside the preliminary injunction. First, the district court noted that Section 362(a)(3) which applies the automatic stay to acts to obtain possession of "property of the estate" was not applicable in this case. "[C]ashing the letter of credit will not divest the estate of

---

\(^12\) 11 U.S.C. § 549.
\(^13\) Page, 18 Bankr. at 715.
property since neither the letter of credit nor its proceeds are property of the estate. In issuing the letter of credit the Bank entered into an independent contractual obligation to pay WCC out of its own assets." Moreover, although cashing the letter will give the bank the right to pursue indemnification against the debtors, the debtors would not be divested of property because the enforcement of that secured claim would be stayed under Section 362(a) (4).

The district court also rejected the contention that cashing the letter of credit would violate Section 362(a)(4)’s prohibition against “any act to create, perfect or enforce any lien against property of the estate.” The bank’s liens on the debtors’ assets to secure the indemnification agreement were created and perfected before the chapter 11 case was commenced. The court viewed the arrangement as a lien created to secure future advances, which is valid against a bankruptcy trustee. “Since perfected liens already exist cashing of the letter of credit cannot have the effect of either creating or perfecting a lien.” Also, cashing the letter of credit is not an act to “enforce” a lien, despite the fact that honoring it would trigger the bank’s secured claim against the debtor, because the bank would be automatically stayed from enforcing its claim.

The district court also found that the bankruptcy court’s reliance on Section 549 was misplaced. That section prohibits postpetition transfers of property of the estate under certain circumstances. The court held that section inapplicable because the “letter of credit and its proceeds represent property of the Bank, not the debtors.”

The bankruptcy court’s finding that cashing the letter of credit would jeopardize the reorganization case was also rejected by the district court. The bank’s right to proceed against the debtors after honoring the letter would be automatically stayed. “Thus the debtors will be provided adequate breathing space to attempt to work out their financial affairs as intended by the Bankruptcy Code.” In addition, the compromising of claims needed for a successful reorganization plan can be achieved by modifying claims of the bank as well as other creditors. Therefore, the debtors’ chances of successfully reorganizing would not be destroyed by the cashing of the letter of credit.

Most comforting to the business community was that the district court emphasized the importance

---

14 Id.; see also In re Clothes, 35 Bankr. 487 (D. N.D. 1983).
16 Page, 18 Bankr. at 716.
17 Id.
18 Id. at 717.
of protecting the reliability of letters of credit as financing devices. "[E]njoining the payment of the letter of credit, even temporarily, would frustrate the commercial purposes of letters of credit to the detriment of financial institutions as well as their customers." 19 The court commented further that "if payment on a letter of credit could be routinely delayed by the filing of a Chapter 11 petition the intended substitution of a bank for its less credit-worthy customer would be defeated. As a consequence the letter of credit would become a dubious device for securing credit." 20 Reconciling the commercial world of letters of credit and federal bankruptcy policy, the court concluded that "where, as here, the goals of the Bankruptcy Code can be achieved without producing this unfortunate result there is obviously no reason not to allow the letter of credit to be cashed according to its terms." 21

M.J. Sales: A Step-by-Step Approach

The vitality of letters of credit presented for payment after the commencement of a bankruptcy case was explored further in In re M.J. Sales & Distributing Co., Inc. 22 The opening words of the bankruptcy court's opinion are worth noting: "An anticipated problem, with shades of In re Twist Cap . . . prompts the trustee in bankruptcy to join in the request" for an order staying actions involving a letter of credit. 23

Therm-O-Ware Electric Corporation had sued and obtained a default judgment against the debtor, M.J. Sales & Distributing Company, Inc., in 1979. The default judgment was vacated on condition that M.J. Sales post a surety bond, which it obtained from Aetna Casualty & Surety Company, to guarantee payment of any judgment that Therm-O-Ware may recover against M.J. Sales. As consideration and security for Aetna's issuance of the bond, M.J. Sales obtained, for the benefit of Aetna, an irrevocable letter of credit in the amount of $25,234, dated October 16, 1979, issued by Bankers Trust Company. Aetna had the right pursuant to the terms of the letter of credit to obtain funds when, in Aetna's sole judgment as surety, such funds are required for Aetna's protection. The letter of credit, which was assigned and assumed by Republic National Bank, was secured with a treasury bond posted by M.J. Sales. All of these transactions took place almost two years before an involuntary chapter 7 petition was filed

19 Id.
20 Id.
21 Id.
23 Id. at 609.
against M.J. Sales on May 6, 1981.

At the time of the filing of the involuntary petition, there was still pending the suit by Therm-O-Ware against M.J. Sales for which the Aetna surety bond had been issued. Therm-O-Ware's complaint to lift the automatic stay in order to continue its suit in the state court was granted by the bankruptcy court without prejudice to the trustee to commence a proceeding to recover any preferential payments. However, M.J. Sales admitted that no further defense would be made in the state court action. Eventually, a second judgment was entered against M.J. Sales in the state court action. Aetna demanded that Bankers Trust pay the letter of credit to cover its obligation under the bond. Bankers Trust responded that the letter of credit had been sold to Republic National Bank which assumed all liability under it.

A complex web of litigation in several courts followed, but most significantly, the trustee obtained a temporary restraining order from the bankruptcy court preventing Republic National from releasing any funds pursuant to the letter of credit. At the subsequent hearing, the court determined that the stay should continue in order to allow the trustee or Republic National to institute an adversary proceeding to determine the rights and obligations of the parties with respect to the letter of credit and the debtor's treasury bond held by Republic National as security for the letter of credit.

The Four-Step Progression

In analyzing the rights of the various parties, the bankruptcy court construed the problem as a "four-step progression" of events: (1) the debtor's pledging the treasury bond as collateral to obtain the letter of credit to support the Aetna bond to vacate the default judgment, (2) Therm-O-Ware's state suit against Aetna to recover under the Aetna bond for its postpetition second judgment against M.J. Sales, (3) Aetna's resort to the letter of credit in order to be reimbursed for payments required under the surety bond, and (4) Republic's recourse against the collateral pledged by the debtor as consideration for the issuance of the letter of credit.

As to step 1, the debtor's pledging of its treasury bond as collateral, the court rejected the trustee's contention that the pledge was a voidable preference. The court found that the pledge of the treasury bond occurred more than ninety days before the filing of the petition and, therefore, could not be a preference under Section 547(b)(4)(A). Moreover, the pledge was protected from prefer-

ence attack because it was a contemporaneous exchange under Section 547(c)(1) in that it was given in consideration for the contemporaneous issuance of the letter of credit. Also, the court found that the pledge was a transfer in the ordinary course of business within the scope of Section 547(c)(2). Nor was the trustee’s argument under Section 547(d) (permitting a trustee to avoid transfers of the debtor’s property that were made to reimburse a surety that furnished a bond to dissolve a judicial lien that would have been avoidable as a preference) tenable since the judgment having been entered more than ninety days before bankruptcy could not have been avoided.

As to step 2, Therm-O-Ware’s state suit against Aetna to recover on the surety bond on account of the postpetition judgment entered against M.J. Sales, the trustee argued that the debtor’s intervening bankruptcy prevented Therm-O-Ware from looking to the Aetna bond for satisfaction of its postpetition judgment obtained against the debtor. However, the court indicated that payment by Aetna to Therm-O-Ware would not reduce the assets of the estate since Aetna would be paying out of its own funds. Thus, Section 549(a) “which permits a trustee to ‘avoid a transfer of property of the estate . . . that occurs after the commencement of the case’ will not come into play” (emphasis added). A similar challenge based on Section 547(d) was answered by indicating that that section prohibited only transfers of the debtor’s property.

Step 3 dealt with Aetna’s reimbursement by the letter of credit. Aetna would pay the judgment creditor, Therm-O-Ware, only if Aetna would be reimbursed by the letter of credit in its favor which the debtor caused Bankers Trust to issue. Therefore, the court considered whether any Bankruptcy Code provisions prohibited payment to Aetna pursuant to the letter of credit for which Republic National was liable.

Originally it was thought that In re Twist Cap, Inc., 1 B.R. 284 (Bkrtcy. Fla 1979) stood for the flat proposition that the honoring of letters of credit obtained by a debtor for the benefit of an unsecured creditor would create a preference in favor of such creditor. . . . [T]he court did not hold that if the letters of credit were honored, the beneficiary would receive a preference. . . . The court merely declared that a temporary restraining order should issue in order to preserve the status quo pending a determination on the merits. The court appeared to be influenced by the fact that the bank held collateral of the debtor to secure its obligations under the letters of credit. However, the diminution in the debtor’s

estate occurred more than ninety days before the petition was filed, at the time when the collateral was pledged; not when the bank looked to its collateral for reimbursement in the post-petition period.\textsuperscript{28}

In this connection, the court observed the function played by the letter of credit in the commercial world.

A bank honors a letter of credit and pays the beneficiary with its own funds, and not with assets belonging to the debtor who caused the letter of credit to be issued.\ldots\textsuperscript{[A]} A letter of credit represents an irrevocable obligation by an issuing bank to pay the beneficiary in accordance with its terms; despite \ldots defenses against the beneficiary not apparent on the face of the letter of credit.\textsuperscript{29}

Comparing the letter of credit with a guarantee, the court held that there was no preference to the holder of a guarantee when paid by the guarantor, notwithstanding the bankruptcy of the obligor whose performance was guaranteed. Indeed, the court followed and quoted extensively from the decision in the \textit{Page}\textsuperscript{30} case. Since the funds from which Republic National must pay the letter of credit did not constitute property of the estate, there were no provisions of the Code that would stand in the way of honoring the letter of credit.

Step 4 in the series of transactions was referred to by the court as the "most critical aspect in this case" which "goes to the heart of the trustee's position."\textsuperscript{31} This step dealt with Republic's recourse to the pledged collateral (the treasury bond) after Republic pays the letter of credit. The trustee argued that Therm-O-Ware could not levy upon the debtor's property because of the automatic stay under Section 362(a)(3) and (4). Therefore, Therm-O-Ware should not be permitted to benefit indirectly from the debtor's pledge of the treasury bond. The indirect benefit would result when Republic National looks to the treasury bond after payment to Aetna under the letter of credit which in turn permitted Aetna to pay Therm-O-Ware under its bond. Thus, the Aetna bond and the letter of credit were conduits permitting Therm-O-Ware to do indirectly what it could not do directly. However, the court rejected the trustee's position. "This argument elides the point that Republic National is similarly prevented by the automatic stay as expressed in 11 U.S.C. § 362(a)(4), from recourse to the debtor's pledged treasury bond."\textsuperscript{32}

This fourth step also offended the trustee's perception that the

\textsuperscript{28} M.J. Sales, 25 Bankr. at 613-614.
\textsuperscript{29} Id. at 614.
\textsuperscript{30} See 18 Bankr. at 713.
\textsuperscript{31} M.J. Sales, 25 Bankr. at 615.
\textsuperscript{32} Id.
debtor's property should not be transferred postpetition. However, referring again to Section 549(a)(1), the court stated that Republic's liquidation of the treasury bond was not a postpetition transfer of an interest in the debtor's property. A security interest in "the treasury bond was transferred by pledge ... more than a year and one-half before this chapter 7 case was commenced."33

Therefore, the court in M.J. Sales concluded that the trustee could not avoid any of the transfers in that case and that there were no provisions in the Bankruptcy Code that would preclude the immediate payment by Republic National to Aetna pursuant to the letter of credit.

Cancellation of a Letter of Credit as a Preference: The Air Conditioning Case

In contrast to the M.J. Sales step-by-step approach to the problem of determining whether any aspect of a letter of credit transaction is voidable, the bankruptcy court in the Air Conditioning case canceled a letter of credit by viewing all aspects of the transaction as "a single contemporaneous transaction"34 that had a preferential effect within the crucial ninety-day preference period.35

On May 10, 1984, a creditor, Leasing Services, obtained a judgment against the debtor for $40,447 on account of an antecedent debt. On April 24 and May 9, two writs of replevin were obtained by the creditor to collect on the same claim. The first writ was executed on the debtor's equipment, but by stipulations signed in June, the parties agreed to replace the unexecuted writ of replevin with a $20,000 letter of credit issued by American Bank of Martin County on June 15, 1984. In consideration for issuance of the letter of credit, the debtor gave the bank its note dated the same day in the sum of $20,000 secured by the assignment and delivery to the bank of the debtor's $20,000 certificate of deposit.

Only one month later, on July 25, the debtor filed a chapter 7 petition. The bank filed an interpleader action asking the court to determine whether it owed $20,000 to the trustee or to the judgment creditor. The trustee claimed that the transactions constituted a voidable preference and that the $20,000 certificate of deposit belonged to the trustee. However, the judgment creditor argued that the first element of Section 547(b)36 was not satisfied because the creditor received only

33 Id. at 616.
34 55 Bankr. at 159.
36 11 U.S.C. § 547(b) provides that a "trustee may avoid any transfer of an interest of the debtor in property (1) to or for the benefit of a creditor..."
the letter of credit which was the bank's property, not the debtor's. The court was urged to reason that during the ninety-day pre-petition period, the only property transferred by the debtor was the certificate of deposit given to the bank for the contemporaneous issuance of a letter of credit. That is, there was no antecedent debt owed to the bank which was the transferee of the property. Then, the bank gave the judgment creditor its letter of credit which was not the debtor's property.

However, the court agreed with the trustee that the "letter of credit was but a part of a single contemporaneous transaction which included (a) the debtor's note to the bank (which bore the notation that its purpose was to establish the letter of credit) and (b) the assignment of the debtor's certificate of deposit." 37 The court considered the intentions of both parties that $20,000 additional collateral for the antecedent debt be furnished to the creditor through the bank as intermediary. "This composite transaction was a transfer of the debtor's property for the creditor's benefit." 38

Clearly, a transfer made to a non-creditor may constitute a preference if it would benefit a creditor and the remaining elements of Section 547(b) are met. The creditor also argued that the transfer of the certificate of deposit was protected by Section 547(c)(1) as "a contemporaneous exchange for new value given to the debtor." 39 The alleged "new value" was the creditor's agreement not to proceed with execution of the writ of replevin. This argument was rejected easily. "Forbearance is not 'new value' as defined in § 547(a)(2)." 40

The court, based on Section 547, nullified the entire letter of credit transaction. The debtor's note given to the bank, the debtor's assignment of its certificate of deposit, and the bank's letter of credit (each in the amount of $20,000), were canceled. The bank was ordered to deliver the certificate of deposit to the trustee.

A Blessing in Disguise

Although this result is consistent with the spirit of Section 547(d), 41 the Air Conditioning decision may be viewed as significant in that it renders letters of

---

37 Air Conditioning, 55 Bankr. at 159.
38 Id.
40 Air Conditioning, 55 Bankr. at 159.
41 11 U.S.C. § 547(d) provides as follows:
(d) The trustee may avoid a transfer of an interest in property of the debtor transferred to or for the benefit of a
credit vulnerable to a preference attack. However, its holding is limited to cases where within ninety days prior to bankruptcy, a letter of credit is issued to a creditor on account of an antecedent debt that is at least partially unsecured and owed by an insolvent debtor who within the ninety-day period also gives the bank collateral to secure the debtor’s obligation to reimburse the bank when the letter of credit is honored. This decision makes good sense because the effect of the transaction is to give the creditor greater rights than it would otherwise have by transferring the debtor’s assets to the bank issuing the letter of credit on the eve of bankruptcy.

It is also worth noting that the result in *Air Conditioning* does not adversely affect the bank because its obligation to honor the letter of credit was canceled. In fact, *Air Conditioning* is a blessing in disguise for banks as well as for debtors in possession and trustees. If the transaction was not nullified, the bank would have had to pay the creditor $20,000 but would be automatically stayed from proceeding against the cash collateral which may be subject to the debtor’s use under Section 363(c)(2)(B), as long as the bank is adequately protected. The only party hurt by the court’s decision was the creditor who should stand in the same shoes as any other creditor receiving a preferential transfer within the ninety-day preference period.

### Addendum

Since this article was submitted to the *Journal*, an appeal to the district court resulted in a reversal in part of the decision of the bankruptcy court. In effect, the district court held that the bank was to honor the letter of credit, satisfy its own claim out of the $20,000 certificate of deposit, and leave the trustee to pursue the collection of the preference against *Leasing Services*. It is noteworthy that the New York Clearing House filed a brief as an amicus curiae urging that the nullifying of a letter of credit was contrary to “well established legal precedent.”

We await the decision of the Court of Appeals for the Third Circuit.

---

43 See *Gross & Borowitz, "A New Twist on Twist Cap: Invalidating a Preferential Letter of Credit in In re Air Conditioning","* 103 Banking L.J. 368 (1986), approving the decision of the *Air Conditioning* case as “correctly [harmonizing] the policies underlying letter-of-credit law and bankruptcy preference law.”