Letters of Credit as Preferential Transfers in Bankruptcy

Gerald T. McLaughlin
LETTERS OF CREDIT AS PREFERENTIAL TRANSFERS IN BANKRUPTCY

GERALD T. McLAUGHLIN*

INTRODUCTION

"DEVIL'S advocate" may be the wrong term but it has been used to describe the trustee in bankruptcy. He is paid to be thorough and pugnacious, "to resist by every available device and stratagem" the assertion of property claims against the bankrupt's assets. In order to carry out his job, federal bankruptcy law provides the trustee with wide ranging powers. Among the most important of these powers is the power to avoid so-called "preferential transfers"—transfers made on the eve-of-bankruptcy which favor some, but not all of a bankrupt's creditors. Although the trustee has been known to use this power with great effect, one type of transfer seemed beyond his grasp. Letter of credit payments were widely assumed to be inviolable and totally immune from attack as preferential transfers. In terms of letter of credit law, this assumption seemed eminently cor-

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* Professor of Law, Fordham University School of Law; B.A. 1963, Fordham College; LL.B. 1966, New York University. The author wishes to thank Professor Paul M. Shupack of Cardozo Law School for reading and commenting on the early drafts of the manuscript. The views presented, however, are solely those of the author.

1. 2 C. Gilmore, Security Interests in Personal Property § 45.2, at 1287 (1965). For the purposes of this Article, the word "trustee" is used in its widest sense to include a trustee in bankruptcy and, where appropriate, a debtor in possession.

2. Id.

3. See, e.g., 11 U.S.C. § 544(a) (Supp. IV 1980) (trustee given lien creditor status as of date of bankruptcy); id. § 545 (trustee given power to avoid fixing of certain statutory liens on debtor's property); id. § 548 (trustee given power to avoid fraudulent transfers).

4. Id. § 547(b) (Supp. IV 1980).

5. Letters of credit represent irrevocable payment obligations of those who issue the letters. Although letters of credit can be revocable, U.C.C. § 5-103(1)(a) (1977), the vast majority are irrevocable in nature. See id. § 2-325(3) with respect to irrevocable letters of credit in sales contracts. Not only are letters of credit normally irrevocable, they are also independent of the transactions that spawned them. That is, if disputes arise between the parties to an underlying sales contract, the issuer of the letter of credit is not thereby free from his obligation to pay the letter. Id. § 5-114 official comment 1. But if, for example, fraudulent or forged documents are presented to the issuer or if there is "fraud in the transaction," the issuer may, depending on the facts, refuse to pay the letter. Id. § 5-114(2). There is some disagreement, however, whether the term "fraud in the transaction" refers to fraud in the underlying contract between the parties or in the letter of credit contract between the issuer and the beneficiary of the letter. See American Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420, 424 (S.D.N.Y. 1979). In this Article, all citations to the UCC are to the 1978 Official Text.
Because a letter of credit normally represented the payment obligation of a bank, it seemed illogical to treat the payment of the bank's obligation as a preferential transfer of the bankrupt's assets.

But in quick succession, two events in the fall of 1979 brought into question the continued validity of this assumption. On October 1, 1979, the new federal Bankruptcy Code (Code) went into effect. In several important respects, the new Code strengthened the trustee's anti-preference power. These changes were so significant that one commentator remarked: "The practical consequence of these changes is that all payments and other transfers within the 90 days preceding the filing of the petition are vulnerable to attack." Just as the bar began to focus on the implications of the trustee's strengthened anti-preference power, a Florida bankruptcy judge decided the case of Twist Cap, Inc. v. Southeast Bank.

In Twist Cap, the plaintiff debtor entered into a security agreement with the defendant, Southeast Bank of Tampa, securing moneys paid by the bank on behalf of the debtor. The bank also issued three letters of credit for the account of the plaintiff payable to defendants Aluminum Company of America and Central Can Company. The last of these letters of credit was issued on March 19, 1979. On August 22, 1979, the plaintiff filed for relief under Chapter XI of the then bank-


7. For example, under prior bankruptcy law, the trustee had to prove as one element of a preference that the transferee had "reasonable cause" to believe that the debtor was insolvent at the time of the transfer. 11 U.S.C. § 96(b) (1976) (repealed by the Bankruptcy Reform Act of 1978, § 401(a), Pub. L. No. 95-598, 92 Stat. 2682). The present preference section, 11 U.S.C. § 547 (Supp. IV 1980), no longer contains this requirement except with respect to certain transfers to "insiders." See id. Similarly, under the new Code, the debtor is presumed to have been insolvent for the 90 days prior to his bankruptcy. Id. § 547(f). In most cases, though, the period in which the trustee can challenge preferential transfers has been shortened from four months to 90 days. Compare 11 U.S.C. § 96(b) (1976) (repealed by the Bankruptcy Reform Act of 1978, § 401(a), Pub. L. No. 95-598, 92 Stat 2682) (trustee may avoid transfers made within 4 months before the filing of the bankruptcy petition) with 11 U.S.C. § 547(b)(4)(A) (Supp. IV 1980) (trustee may avoid transfers of the debtor's property made within 90 days before the filing of the petition of bankruptcy). On December 16, 1981, S. 2000, 97th Cong., 1st Sess., 188 Cong. Rec. S15,712 (daily ed. Dec. 16, 1981), was introduced into the Senate. This bill would reinstate the prior law's general requirement that the trustee prove that the creditor transferee had reasonable cause to believe that the debtor was insolvent when the transfer was made within the 90 day period. Id. § 10(a)(6). If this bill were to become law, the trustee would again be faced with the difficult task of proving the state of mind of the creditor-transferee before he could avoid a preference.


ruptcy law. The plaintiff requested the court to issue an order re-
straining the bank from honoring the letters of credit. The judge
granted a preliminary injunction, suggesting, inter alia, that letter of
credit payments from a secured bank to unsecured creditors might
constitute preferential treatment of the unsecured creditors. In
isolation, the decision in Twist Cap would have been nothing more
than a troubling lower court precedent. But coming as it did soon
after the effective date of the Code’s new preference provisions, Twist
Cap sent tremors through the business community. Letters of credit
have always been thought to represent inviolable payment obliga-
tions. They are used to assure payment for goods in international
sales transactions; they serve as loan repayment guarantees; and
they support the creditworthiness of large amounts of commercial
paper and industrial revenue bonds. In all of these transactions,
letters of credit are used to place the risk of buyer or debtor bank-
ruptcy on the issuing bank. If letter of credit payments could now be
avoided as preferential transfers, the risk of bankruptcy would be
placed back on the creditor, thus undermining the purpose of letters of
credit. They would no longer serve as hedges against the possible
bankruptcy of buyers or commercial borrowers.

Twist Cap and the new Bankruptcy Code have forced the bar to re-
analyze old assumptions about letters of credit. This Article argues,
however, that the old assumptions still remain the correct assump-
tions—letter of credit payments should not constitute preferential
transfers. To justify this conclusion, Part I of this Article defines a
letter of credit, discusses the two types of letters of credit, commercial

10. 1 Bankr. at 285.
11. Id. The opinion in Twist Cap does not state which type of letter of credit—
commercial or standby—was involved in the dispute. On balance, it appears to be a
commercial letter of credit. See infra note 94. As a practical matter, much of the
impact of Twist Cap would be reduced if S. 2000, see supra note 7, became law. If
the “reasonable cause” requirement is put back into the law as an element of a
preference, the trustee would not be able to recover many letter of credit payments
made by an issuing bank to a beneficiary. The trustee might be hard pressed to prove
that the beneficiary had reasonable cause to believe that the customer was insolvent
at the time he was paid by the bank.
12. See supra note 5.
13. See, e.g., Corporacion de Mercadeo Agricola v. Mellon Bank Int’l, 608 F.2d
465, 466-67 (Bankr. D. Minn. 1980); see also N.Y. Times, Mar. 26, 1982, at D1
(refers to Nigeria’s use of letters of credit as its “main form of import financing”).
(Tex. 1978); Baird, Standby Letters of Credit in Bankruptcy, 49 U. Chi. L. Rev. 130,
136 (1982).
15. See Ryan, Letters of Credit Supporting Debt Instruments, in Letters of
Credit 195 (Practising Law Institute Course Handbook Series No. 251 R. Ryan ed.
and standby letters, and explains the fundamental differences between them. Part II analyzes commercial letter of credit payments in the light of the anti-preference provisions of the new Bankruptcy Code. Part III examines the related question of whether standby letter of credit payments can constitute preferential transfers.

I. THE LETTER OF CREDIT: FORMS AND FUNCTIONS

Letters of credit are of two kinds—the commercial letter of credit and the standby letter of credit.\(^{16}\)

A. The Commercial Letter of Credit

The commercial letter of credit has been defined as a "mechanism of payment utilized in a transaction involving the sale of goods."\(^{17}\) This definition will be more understandable when we see precisely how the commercial letter of credit functions in the overall sale transaction. For example, assume a California buyer wishes to purchase $500,000 worth of widgets from a seller in Florence, Italy. Typically the buyer will approach the seller and ask him to ship the requisite number of widgets to California. Because the parties live in different countries, separated by thousands of miles, and are dealing with each other for the first time, the terms of delivery and payment will be carefully negotiated. The seller will suggest that the buyer pay for the widgets before shipment. Advance payment eliminates all of the seller's transactional risks.\(^{18}\) For example, if the seller had to await payment until the widgets reached California, he would bear the risk of intervening buyer insolvency or adverse currency fluctua-
Similarly, the buyer could reject the widgets outright or refuse to pay the full purchase price, claiming some real or imagined non-conformity with respect to the widgets. The Italian seller would then either have to dispose of the widgets in the California market or sue for the full purchase price in a California court.

Although advance payment eliminates the seller's transactional risks, it also creates transactional risks for the buyer. If the buyer pays for the widgets in advance, he runs the risk of seller dishonesty. For example, the seller may either not ship the widgets or he may ship non-conforming widgets.

By structuring payment for the goods around a commercial letter of credit, the mutual concerns of seller and buyer can be substantially reduced, if not totally eliminated. Buyer and seller will first enter into a contract for the sale of the widgets; this underlying contract of sale will be called "Contract I." As part of this contract, the seller and the buyer will agree that the buyer will pay for the widgets by procuring a commercial letter of credit in favor of the seller. Pursuant to Contract I, the buyer will go to an agreed upon bank in California and contract with the bank to issue an irrevocable commercial letter of credit in the seller's favor. This contract between the bank, now called the "issuer," and the buyer, now called the "customer," will be called "Contract II." In Contract II, the issuing bank will agree to honor the seller's draft assuming conditions specified by the customer are met. Typically the customer will specify that the bank should pay only after the seller presents the bank with (i) a bill of lading evidencing shipment of the goods, (ii) a commercial invoice and (iii) other specified documents such as a marine insurance policy or a certificate of quality. In addition, the customer will agree in Contract II to reimburse the bank for payments made on his behalf. To secure such reimbursement, the bank will normally demand a security interest in the goods, documents and property rights involved in the sale transaction. Once Contract II has been signed, the issuing bank will then issue its irrevocable letter of credit in favor

23. See id. § 5-103(1)(g).
24. For a model of such a contract between the bank-issuer and the buyer-customer, see H. Harfield, supra note 19, at 310-17 app. c.
25. Id. at 310 app. c.
26. Id. at 312 app. c.
27. Id. at 313 app. c.
of the seller, now called the "beneficiary." This final "contract" will be called "Contract III." This issuer-beneficiary "contract" commits the bank to honor the beneficiary's draft for $500,000 upon the presentation of the required documents. It is important to note that the issuing bank's obligation under Contract III is totally separate and independent from Contracts I and II. Once the bank's commitment to the beneficiary has been "established," the bank cannot legally refuse to pay the beneficiary if some dispute arises with respect to the underlying sales contract between the buyer and seller, Contract I, or with respect to the contract between the bank and buyer, Contract II.

When the beneficiary seeks recovery against the bank by presenting his draft and the necessary documents, the bank (i) can legitimately defer payment for three banking days after receiving the documents and seek to be put in funds from the customer before paying the beneficiary or (ii) can first pay the beneficiary and then seek reimbursement from the customer. By following this latter course, the bank essentially lends the money to the customer. In seeking reimbursement of the loan, the bank has the right to only one payment from the customer, although it can claim that payment on one of two theories: (i) by paying the beneficiary, the bank becomes subrogated to the seller-beneficiary's payment claim against the customer under Contract I; and (ii) by paying the beneficiary, the bank has its own independent payment claim against the customer under Contract II.

30. See H. Harfield, supra note 19, at 322-28 (examples of various letters of credit).
31. For the rules governing "establishment" of letters of credit, see U.C.C. § 5-106 (1977).
32. See, e.g., East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co., 593 F.2d 598, 602 (5th Cir. 1979); Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077, app. A at 1081-82 (6th Cir. 1977) (per curiam); H. Harfield, supra note 19, at 72-73.
35. For an excellent discussion of the issuing bank's subrogation rights under a letter of credit, see Jarvis, Standby Letters of Credit—Issuers' Subrogation and Assignment Rights (pts. 1 & 2), 9 U.C.C. L.J. 356, 10 U.C.C. L.J. 38 (1977); see also B. Clark, The Law of Bank Deposits, Collections and Credit Cards § 8.11 (rev. ed. 1981) (discussing the issuer's right of subrogation in situations of customer bankruptcy).
Once the mechanics are understood, it is easy to see how the commercial letter of credit reduces and, in some cases, eliminates the mutual risks of the international sale.\footnote{37} For example, the seller may be concerned that, if he ships the goods before being paid, the buyer may go bankrupt or try to force a price discount by fabricating some defect in the goods. Once the letter of credit has been "established" in the seller's favor, however, it effectively eliminates both of these risks.\footnote{38} The bank will presumably not go bankrupt and will be required to pay the seller regardless of the buyer's real or fabricated complaints with respect to the goods. On the other hand, the buyer may be concerned that once he pays for the goods, the seller may renege on shipping. The letter of credit will assure the buyer that payment will not be made until the seller presents evidence that the goods have in fact been shipped. The seller cannot be paid until a conforming bill of lading is presented to the bank. If, on the other hand, the buyer is concerned that the seller may ship non-conforming goods, the buyer can require as a condition of payment that the seller submit a certificate of quality from a neutral third-party inspector.\footnote{39}

\section*{B. The Standby Letter of Credit}

Standby letters of credit are most frequently used to guarantee payment obligations in non-sales transactions.\footnote{40} Standby letters can be used in lieu of a performance bond from a surety\footnote{41} or to secure payment of a stipulated damages clause in a contract.\footnote{42} In real estate finance contracts, they often serve to guarantee that a customer will

\footnote{37. \textit{See} J. White & R. Summers, supra note 8, § 18-1, at 704-08.}
\footnote{38. Once an irrevocable letter of credit is "established" as regards the beneficiary, the issuing bank cannot unilaterally modify or cancel its terms. \textit{Id.} § 5-106(2). In a sense, an irrevocable letter of credit does not become fully irrevocable until it is "established." \textit{See infra} note 111.}
\footnote{39. U.C.P. art. 31.}
\footnote{40. For a discussion of the many uses to which standby letters of credit have been put, see Joseph, \textit{Letters of Credit: The Developing Concepts and Financing Functions}, 94 Banking L.J. 816 (1977). A definition of a standby letter of credit can be found in the regulations promulgated by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, 12 C.F.R. §§ 7.1160(a), 208.8(d)(1), 337.2(a) (1981). For example, the Board of Governors of the Federal Reserve defines the standby letter of credit as "an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation." 12 C.F.R. § 7.1160(a) (1981).}
\footnote{41. National Sur. Corp. v. Midland Bank, 551 F.2d 21, 23-24 (3d Cir. 1977) (per curiam); \textit{see} Victory Carriers, Inc. v. United States, 467 F.2d 1334, 1340 (Cl. Ct. 1972).}
take up a mortgage loan commitment. Perhaps their most common use, however, is to guarantee the repayment of a loan.

Although the standby and commercial letters of credit normally serve different business functions, their structure and operation are basically the same. Both letters involve three contracts. In the case of a standby letter guaranteeing repayment of a loan, the creditor and the debtor first enter into their basic loan agreement—"Contract I." To guarantee repayment of the loan, the debtor will then contract with the issuing bank to "establish" a letter in the creditor's favor. In this contract between the debtor and the issuing bank, "Contract II," the debtor will specify that the bank should pay the creditor's draft only if the creditor presents the bank with specified documents. Normally the only documents specified are the debtor's note endorsed over to the bank and a certificate of default—a writing signed by the creditor, stating that the debtor has failed to make good on his note payments. In Contract II, the debtor will also agree to repay the bank for any amounts paid on his behalf and give the bank a security interest in some of his assets to secure repayment of these amounts. Based on its contract with the debtor, the bank will then issue the standby letter of credit in the creditor's favor, "Contract III," committing itself to repay the debtor's note if and when the debtor defaults. Just as with the commercial letter of credit, the bank's payment commitment is irrevocable and completely independent of the two contracts that preceded it. Similarly, if the bank has to honor its payment obligation, it is subrogated to the creditor's claim against the debtor under Contract I and has its own independent reimbursement claim against the debtor under Contract II.

II. COMMERCIAL LETTER OF CREDIT
PAYMENTS AS PREFERENTIAL TRANSFERS

In an ordinary sale transaction, the buyer pays the price of the goods directly to the seller. When a commercial letter of credit is used,

43. See Shel-Al Corp. v. American Nat'l Ins. Co., 492 F.2d 87, 95 (5th Cir. 1974).
44. See supra note 14 and accompanying text.
45. The endorsement will usually be without recourse and with a disclaimer of certain warranty liability. Of course, if the customer-debtor refuses to pay the promissory note when it is due, and the beneficiary obtains payment from the issuing bank, the overdue promissory note endorsed over to the issuing bank by the beneficiary does not make the bank a holder in due course. One cannot be a holder in due course of an instrument if the instrument is taken with knowledge that it is overdue. U.C.C. § 3-302(1)(c) (1977).
46. See Postal v. Smith (In re Marine Distrib., Inc.), 522 F.2d 791, 793 (9th Cir. 1975).
47. See supra note 29.
48. See supra note 35 and accompanying text.
49. See supra note 36 and accompanying text.
the issuing bank pays the seller the price of the goods and then is reimbursed by the buyer. Part II of this Article analyzes how the law of preferential transfers affects (1) a sale of goods when payment is made directly from seller to buyer, and (2) a sale of goods when payment is made through a commercial letter of credit.

A. The Ordinary Sale

Under federal bankruptcy law, a trustee may avoid some, but not all, eve-of-bankruptcy transfers of the assets of the bankrupt. He may avoid so-called "preferential transfers." To constitute a "preferential transfer," the transfer must meet six conditions. It must be (i) of the debtor's property, (ii) to or for the benefit of a creditor, (iii) for or on account of an antecedent debt, (iv) made while the debtor was insolvent, (v) made within ninety days before filing of the bankruptcy petition, and (vi) be a transfer that enables the creditor to receive more than he would receive under a liquidation of the debtor's assets. With respect to conditions (iv) and (v), the Code creates a

50. Under the new federal bankruptcy law, it is clear that the bankruptcy courts would have jurisdiction to adjudicate actions to avoid preferential transfers. Section 1471 of Title 28 of the United States Code grants to bankruptcy courts broad jurisdiction over matters pertaining to bankruptcy actions. 28 U.S.C. § 1471 (Supp. III 1979). This broad jurisdiction encompasses actions to avoid preferential transfers. See 1 Collier on Bankruptcy ¶ 3.01(d), (e) (15th ed. 1981). Under the prior bankruptcy law, a distinction was made between the "summary jurisdiction" of a bankruptcy court and the "plenary jurisdiction" of a state court or a federal district court sitting in law or equity but not as a bankruptcy court. Id. ¶ 3.01, at 3-22. This jurisdictional division resulted in many procedural battles between trustees and defendants. Id. ¶ 3.01, at 3-46. "From the point of view of the creditors, the ability of the trustee to utilize the summary jurisdiction of the bankruptcy courts is of great importance. Plenary suits are extremely time-consuming; and in some jurisdictions, because of congested calendar conditions, it takes several years to obtain a trial." A. Paskay, supra note 9, § 2.008, at P-97 (rev. ed. 1978). Depending on the facts, an action by a trustee to avoid a preferential transfer might have been either within the summary jurisdiction of the bankruptcy court or the plenary jurisdiction of the state or federal district court. Id. § 2.010, at P-108 to 09.

51. 11 U.S.C. § 547(b) (Supp. IV 1980). This section reads in full: "Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made—(A) on or within 90 days before the date of the filing of the petition; or (B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer—(i) was an insider; and (ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and (5) that enables such creditor to receive more than such creditor would receive if—(A) the case were a case under chapter 7 of this title; (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." Id.
rebuttable presumption that the debtor was insolvent during the ninety days immediately preceding the filing of the bankruptcy petition.\textsuperscript{52} How does this definition of a preferential transfer affect a typical sales transaction?

Sale I: Cash Sale—On April 1, Buyer comes to Seller’s plant and buys $500,000 worth of goods, paying for the goods in cash. On June 1, however, Buyer files a voluntary petition in bankruptcy.

Under prior bankruptcy law, it was clear that the buyer’s trustee could not retrieve the $500,000 paid Seller on April 1. First, there could be no question of a preferential transfer unless the transfer depleted the bankrupt debtor’s assets.\textsuperscript{53} Because the $500,000 payment was in exchange for $500,000 worth of goods, there was no depletion of debtor’s assets; there was merely a present substitution of an equivalent value of goods for $500,000 in cash. Case law was clear on this point. For example, in Gray v. Tantleff\textsuperscript{54} the court refused to find an unlawful preference when cash was turned over as a present consideration for the purchase of an equivalent amount of goods.\textsuperscript{55} Second, even without this equivalency argument, the $500,000 payment could not be considered a preferential transfer because the payment was not for an antecedent debt. Under the Uniform Commercial Code (UCC), a buyer is not ordinarily obligated to pay for goods until he receives them.\textsuperscript{56} Because the delivery of the goods and the payment of their price on April 1 were simultaneous acts, the resulting transfer was on account of a contemporaneous, rather than an antecedent, debt. Nothing in the new Bankruptcy Code would change this result.\textsuperscript{57}

Sale II: Sale by Check—On April 1, Buyer comes to Seller’s plant and buys $500,000 worth of goods, paying for the goods by a check

\textsuperscript{52} Id. \S 547(f).
\textsuperscript{53} See 4 Collier on Bankruptcy, supra note 50, \S 547.21.
\textsuperscript{54} 273 F. 524 (E.D.N.Y. 1921).
\textsuperscript{55} Id. at 525; accord Stock Clearing Corp. v. Weiss Secs., Inc., 542 F.2d 840, 843 (2d Cir. 1976) (cash payment for fair value of goods received not a preference); In re Perpall, 271 F. 466, 468-69 (2d Cir. 1921) (cash transaction by bankrupt for value received at the time not a preference).
\textsuperscript{56} U.C.C. \S 2-310(a) (1977). Actually, the UCC states that the buyer, absent agreement to the contrary, must pay for the goods at the time and place he is to receive them. \textit{Id.} This distinction is necessary in the event the goods are lost after the risk of loss has passed to the buyer. \textit{See} R. Nordstrom, Handbook of the Law of Sales \S 115, at 344-45 (1970).
\textsuperscript{57} In fact, the new Bankruptcy Code liberalizes this rule somewhat. Under \S 547(c)(1), a transfer which is intended to be contemporaneous, but which is only substantially contemporaneous, is still exempted from preference attack. 11 U.S.C. \S 547(c)(1) (Supp. IV 1980); see 4 Collier on Bankruptcy, supra note 50, \S 547.37 [2].
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drawn on C Bank. Seller presents the check for payment on April 2 and Buyer's account at C Bank is debited on April 3. On June 1, Buyer files a voluntary petition in bankruptcy.

Sale II differs from Sale I only in the method of Buyer's payment for the goods. Here payment is made by check, not cash. Payment by check is considered conditional, and because Buyer's account was not debited until April 3, it could be argued that Seller has extended credit to Buyer for two days, thus making the transfer of the cash on April 3 a transfer for an antecedent debt. Case law has consistently held, however, that as long as the parties intend a cash sale, the acceptance of a check "does not change a cash sale into a credit transaction."

This position is also adopted by the new Bankruptcy Code. Section 547(c)(1) specifically declares that a transfer intended to be a contemporaneous exchange for new value which is in fact a substantially contemporaneous exchange is not to be treated as a preferential transfer.

Parties who pay by check intend payment to be made when the check is delivered. Because the parties intended that the exchange of goods for money be contemporaneous and because that exchange was in fact substantially contemporaneous, the April 1 payment by check in Sale II is not a preferential transfer. Thus, with respect to preference law, Sale II is treated as the equivalent of Sale I.

Sale III: F.O.B. Sale

On March 25, Seller in Los Angeles and Buyer in Atlanta enter into a written contract for the sale of $500,000 worth of goods. In the contract, Seller agrees to ship Buyer the goods on April 1, F.O.B. Los Angeles. On April 1, Seller packages and ships conforming goods by rail via a nonnegotiable (or straight) bill of lading naming Buyer as consignee. The goods arrive in Atlanta on May 1. Buyer inspects them, finds them to be

61. For the definition of an F.O.B. term, see U.C.C. § 2-319(1) (1977). An F.O.B. shipment contract will usually involve a sight draft. See R. Nordstrom, supra note 56, § 115, at 344. This element has been omitted from Sale III in order to create a gradual progression of more complicated sales. The sight draft is included in Sale IV—the C.I.F. sale. Most domestic railway bills of lading are straight bills. 1 C. Gilmore, supra note 1, § 1.4 at 17.
conforming and gives Seller's agent in Atlanta a $500,000 check. On June 1, Buyer files a voluntary petition in bankruptcy.

If the payments in Sales I and II above were not preferential, one would anticipate the same result with respect to the May 1 payment in Sale III. Under the UCC, the time and place of delivery in the F.O.B. contract in Sale III is Los Angeles on April 1. If Buyer, however, is not required to pay for the goods at the technical delivery point but rather at the time when and the place where he receives the goods—here, Atlanta on May 1. The debt for the price is thus created when the $500,000 payment becomes due. Because Buyer paid the debt immediately when it became due on May 1, it would be illogical to treat the transfer as one for an antecedent debt. This may not, however, be the correct analysis under the new Bankruptcy Code.

Section 547(c)(2) of the new Code declares that the trustee may not avoid as a preference a transfer made "in payment of a debt incurred in the ordinary course of business... of the debtor [here Buyer] and the transferee [here Seller]" and made "not later than 45 days after such debt was incurred." In terms of Sale III, one would naturally assume that Buyer's debt was "incurred" when it first became due and payable on May 1. If this were the case, payment on May 1 would presumably be a transfer for a contemporaneous, not an antecedent debt. Thus there should be no need to rely on the forty-five day grace period in section 547(c)(2) to exempt the May 1 payment from preference challenge.

There is substantial evidence, however, that for the purposes of section 547(c)(2), a debt is considered "incurred" when payment is earned by the seller. If this rule were applied to Sale III, the debt would be "incurred" on April 1—the date when the goods were

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62. Under the UCC, an F.O.B. place of shipment contract requires the seller "at that place [to] ship the goods" in the manner provided in § 2-504 of the UCC. U.C.C. § 2-319(1)(a) (1977). When the seller complies with § 2-504, he is considered to have tendered the goods at the place of shipment. Id. § 2-503(2). Under the UCC, the time of delivery is subject to the agreement of the parties. Id. § 2-309(1).

63. Id. § 2-310 (a). But see supra note 56.

64. 11 U.S.C. § 547(c)(2) (Supp. IV 1980). The full text of § 547(c)(2) reads: "The trustee may not avoid under this section a transfer—... (2) to the extent that such transfer was—(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made not later than 45 days after such debt was incurred; (C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (D) made according to ordinary business terms." Id.

identified to the contract and shipped from Los Angeles. With respect to the actual dates posited in Sale III, the May 1 payment would still not constitute a preference because of the forty-five day grace period. Had the goods taken more than forty-five days to reach Atlanta, however, the result would have been different. Even if the buyer paid the price of the goods on the due date, the trustee could still argue that this payment was a transfer for an antecedent debt because for bankruptcy purposes the debt was "incurred" not on the date it was first due but rather on the date the seller shipped the goods. One commentator has deplored this reading of the term "incurred": "If under Section 547(c)(2) a debt is considered 'incurred' when the seller performs (i.e., when it ships), those sellers with nonnegotiable bills of lading naming the buyer as consignee who receive payment documents more than forty-five days after shipment may be in danger of preference attack." In terms of bankruptcy policy, it may be preferable to consider a debt "incurred" on the date it first becomes due and payable. If this approach were adopted, then all timely payments in shipment contracts would be immune from preference attack. But if the debt is considered "incurred" when the seller ships the goods, then even timely payments may sometimes constitute preferences.

Sale IV: C.I.F. Sale—On March 25, Seller in France and Buyer in Atlanta enter into a written contract for the sale of $500,000 worth of goods. The contract calls for the shipment of the goods C.I.F. Atlanta on April 1. As required in a C.I.F. contract, Seller puts conforming goods in possession of an appropriate carrier, obtains a negotiable bill of lading covering the transportation of the goods to Atlanta and procures the necessary insurance. On April 1, the goods are shipped by boat to Atlanta. Seller forwards the negotiable bill of lading made out to his order, his sight draft for $500,000, the insurance policy and other necessary shipping documents through banking channels. The draft and documents arrive in Atlanta on April 15. Since the delivery term in the contract was C.I.F., Buyer has agreed to pay the $500,000 purchase price not when the goods arrive but rather when the shipping documents arrive. Consequently, Buyer pays Seller's sight draft for $500,000 and receives in return the negotiable bill of lading properly endorsed. The goods arrive in Atlanta on May 25. On June 1, Buyer files a voluntary petition in bankruptcy.

66. If the goods had been identified to the contract earlier than the date of shipment, the debt might be considered "incurred" at that time. See 4 Collier on Bankruptcy, supra note 50, ¶ 547.38.
67. Tait & Williams, supra note 65, at 65.
68. Id. at 65-66.
69. The term C.I.F. is defined in U.C.C. § 2-320 (1977). To avoid conflicts-of-law problems, this Article assumes that all international sales contracts are governed exclusively by the UCC.
For basically the same reasons as explained in Sale III, the April 15 payment against the bill of lading should not constitute a preferential transfer.\(^7\) If the debt is considered incurred on the date when it first became due—here, April 15, the date when the documents arrive\(^7\) then the $500,000 payment was a transfer for a contemporaneous debt. If, however, the debt is considered incurred on April 1 when the goods were shipped from France, then the April 15 payment would be on account of an antecedent debt. The payment, however, would still not constitute a preference because of the forty-five day grace period in section 547(c)(2).\(^7\)

There is an even more compelling reason, however, why the April 15 payment in Sale IV should not constitute a preference. In Sale IV, Seller is a perfected purchase money secured creditor. A C.I.F. contract requires that the seller ship pursuant to a negotiable bill of lading.\(^7\) Under the UCC, a seller who ships goods pursuant to a negotiable bill of lading retains a security interest in the goods shipped.\(^7\) Because he is securing payment of the purchase price, Seller in effect retains a purchase money security interest in the goods shipped.\(^7\) Preferential transfers of Buyer's assets, however, can occur in various ways. The creation of a security interest in Buyer's tangible goods within ninety days of bankruptcy can constitute a preferential transfer just as readily as the transfer of money.\(^7\) Of course, to be preferential, the transfer of the security interest must be for an antecedent debt.

In Sale IV, determination of whether the transfer of the security interest was for an antecedent debt requires careful analysis. Step I is to determine when the debt between Seller and Buyer arose. Under the Bankruptcy Code, a debt "means liability on a claim" and a claim is defined as "a right to payment, whether or not such right is . . . contingent, matured, or unmatured."\(^7\) Seller clearly earned his right to payment from Buyer on April 1 when he shipped conforming goods and forwarded the negotiable bill of lading to Buyer. Assuming that the debt owed Seller was therefore incurred at the time of shipment, Step II is to determine when the purchase money security interest

\(^{70}\) See supra note 62-68 and accompanying text.

\(^{71}\) In a C.I.F. contract, the buyer agrees to pay when the documents arrive, not when the goods arrive. U.C.C. § 2-320(4) (1977).

\(^{72}\) See supra notes 64-66 and accompanying text.


\(^{74}\) Id. § 2-505(1)(a).

\(^{75}\) The UCC definition of a purchase money security interest is contained in § 9-107. Id. § 9-107.

\(^{76}\) The Bankruptcy Code defines transfer as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest." 11 U.S.C. § 101(40) (Supp. IV 1980). Although retention of title as a security interest is specifically designated as a transfer, the definition is broad enough to encompass the creation of any security interest, purchase money or otherwise.

interest was transferred. Once both the time of the debt and the time of the transfer are identified, it can be determined by comparing the two whether the debt is antecedent to the transfer. A security interest cannot be transferred until it first exists. Under the UCC, a security interest cannot exist until it “attaches” to the goods serving as collateral.78 “Attachment” cannot occur until a security agreement is signed, the seller gives value to the buyer and the buyer in turn has rights in the collateral.79 In this case, because Seller’s security interest arises solely under section 2-505, the UCC dispenses with the need for a formal security agreement.80 Under the facts of Sale IV, Seller gives value to Buyer no later than the date he ships the goods.81 But a buyer cannot have rights in the collateral until the collateral, here the goods being sold, are identified to the contract.82 In the absence of agreement, identification will occur at or slightly before the time of shipment.83 Thus, Seller’s security interest should “attach” at the time of shipment on April 1, which, of course, is exactly the point in time that the debt between Seller and Buyer was incurred. Under section 547(b) of the Bankruptcy Code, however, it is not important that the debt and the attachment of the security interest be simultaneous, rather the debt and the transfer of the security interest must be simultaneous.84

This requires a Step III in the analysis. Under bankruptcy law, a transfer of a security interest takes place at attachment only if the seller perfects his security interest within ten days of its attachment; otherwise the transfer takes place at the time of perfection.85 Because the collateral in Sale IV was the shipped goods and since a negotiable document of title “locks up” the goods,86 Seller could perfect his

79. Id. § 9-203(1)(a)-(b). Possession of the collateral pursuant to agreement, however, can substitute for a signed security agreement. Id.
80. Id. § 9-113(a).
81. It could be argued that Seller gives value on March 25, the day the sale contract was signed. See id. § 1-201(44)(d). A “value” date of March 25, however, would not change the analysis. Unless explicitly agreed to the contrary, attachment takes place upon the occurrence of the last of the three events, id. § 9-203(2), and here the debtor would still not have rights in the goods until the approximate time of shipment on April 1.
82. See id. § 2-501(1).
83. Id. §§ 2-105(2), 501(1)(b).
84. A preferential transfer occurs when the debt is antecedent to the transfer of the bankrupt’s property. The transfer may or may not occur at the time of attachment depending on the time of perfection. 11 U.S.C. § 547(e)(2) (Supp. IV 1980).
85. Id. § 547(e)(2)(A), (B). In § 547(e)(2)(A), the Bankruptcy Code speaks of the transfer being made “at the time such transfer takes effect between the transferor [debtor] and the transferee [creditor], if such transfer is perfected at, or within 10 days after, such time.” Id. The point at which the transfer takes effect between the transferor and the transferee is the point of attachment. See U.C.C. § 9-203(2) (1977).
86. See U.C.C. § 9-304(2) & official comment 2 (1977); 2 G. Gilmore, supra note 1, § 24.1, at 642-43.
security interest in the goods by perfecting his security interest in the document. The UCC permits Seller to perfect his security interest in a negotiable document by possession. Possession can be by the seller himself or by his agent, here, the bank or banks forwarding the negotiable document to Atlanta. In Sale IV, because of the forwarding banks’ continuous possession of the negotiable document, Seller would have a perfected purchase money security interest in the goods from the time of shipment on April 1 until the purchase money security interest is satisfied by Buyer’s payment of the price on April 15. Thus both the debt and the transfer of the security interest occurred simultaneously on April 1. Consequently, under bankruptcy law, the transfer of the security interest was not for an antecedent debt.

Step IV in the analysis is simple. If Seller has a perfected security interest that is not a preference, then Seller would have to be paid as a perfected secured creditor in a liquidation of Buyer’s estate. Hence, under section 547(b)(5), the April 15 payment of $500,000 to satisfy Seller’s security interest would not constitute a preferential transfer. Seller would not receive more than he was entitled to had there been a liquidation. In a sense the payment could also be viewed as a substitution of assets—Buyer paid Seller money and Seller freed Buyer’s property of the pro tanto amount of his secured claim.

Thus in the ordinary face-to-face cash sale (Sale I), the normal check sale (Sale II), the F.O.B. sale (Sale III) and the C.I.F. sale involving a sight draft (Sale IV), Buyer’s payments of the purchase price of the goods to Seller within ninety days of Buyer’s bankruptcy would not ordinarily constitute a preference.

B. The Commercial Letter of Credit Sale

It remains now to be seen whether these conclusions with respect to non-letter of credit sales should be changed when payment for goods is effected by a commercial letter of credit. Several different variants of the commercial letter of credit sale must be considered. In each variant, the bankruptcy of the customer is made to occur after the

88. Id. § 9-305.
89. Id. § 9-305 official comment 2.
91. If the trustee attempted to show that the creditor was receiving more, he would have to “project a pro forma liquidation, making a provisional determination as to the priority, validity, and collectible amount of unsettled claims.” Counsel’s Corner, 98 Banking L.J. 264 (1981). The trustee has the burden of proof on each element of a preference and, in most cases, this element may be difficult for him to establish. Disputed questions of fact will invariably arise with respect to the trustee’s projections.
92. See 4 Collier on Bankruptcy, supra note 50, ¶ 547.21-.22.
issuing bank has paid the beneficiary and the customer has reimbursed the issuing bank. 93

93. In the hypothetical sales that follow, the author consciously chose to have the customer’s bankruptcy occur after all letter of credit payments had taken place to avoid any question of the applicability of the automatic stay provision of § 362(a) of the Bankruptcy Code. 11 U.S.C. § 362(a) (Supp. IV 1980). Once a bankruptcy petition has been filed, § 362(a) provides, inter alia, for an automatic stay of (i) “the commencement or continuation” of most judicial or administrative proceedings “against the debtor,” (ii) “any act to obtain possession of property of the estate,” (iii) “any act to . . . enforce any lien against property of the estate,” and (iv) “any act to collect . . . or recover a claim against the debtor.” Id. If the customer went bankrupt prior to the beneficiary’s demand for payment, an argument could be made that the beneficiary’s demand for payment from the issuing bank could be subject to the automatic stay provision of § 362(a). The author concludes that the stay does not apply to a demand or payment pursuant to Contract III. First, the demand is not an administrative or judicial proceeding against the debtor under § 362(a)(1). Collier on Bankruptcy supports this view: “[W]here the litigation is directed . . . against a guarantor or other third party liable upon the debts of the debtor, courts have rarely acted to issue injunctions, on the ground that they lack jurisdiction to do so, a view that should remain unchanged.” 2 Collier on Bankruptcy, supra note 50, ¶ 362.04(1) at 362-28 to-29. Second, the issuing bank’s payment to the beneficiary under Contract III is out of its own assets, not the assets of the customer. If the bank-beneficiary payment does not constitute “property of the debtor” within the meaning of § 547(b), it should not constitute “property of the estate” within the meaning of § 362(a)(3). Westinghouse Credit Corp. v. Page, No. 81-3172, slip op. at 3-4 (D.D.C. Mar. 30, 1982). Third, for the reasons discussed in Westinghouse, the paying of the letter would not “enforce a lien against the property of the estate under § 362(a)(4). Id. at 4-5. Fourth, the demand of the beneficiary does not constitute an act “to recover a claim against the debtor.” The letter of credit suspends the beneficiary’s claim against the customer and thus the beneficiary’s demand is simply an act to recover a claim against the bank. The case of Joe DeLisi Fruit Co. v. Minnesota, 11 Bankr. 694 (D. Minn. 1981), however, may present some contrary authority on this question. In DeLisi, plaintiff, a dealer in wholesale products, was licensed by the Minnesota Department of Agriculture. As part of the licensing arrangement, plaintiff provided a letter of credit to guarantee performance of certain acts mandated by statute. Plaintiff unfortunately filed for bankruptcy on January 7, 1981. Certain suppliers who were not paid by plaintiff wholesaler wished to make a claim under the letter. As required by Minnesota statute, the suppliers filed a complaint with the Commissioner of Agriculture. On March 20, 1981, the Commissioner of Agriculture issued a “Notice of and Order for Hearing” in the matter. Plaintiff sued to determine whether the automatic stay of § 362 prohibited the hearing from proceeding. Id. at 695. The court decided that the automatic stay did prohibit the beneficiaries—suppliers—from proceeding with their action to recover from the issuing bank under Contract III because the beneficiaries were required to commence an “administrative, quasi judicial proceeding.” Id. at 696. Thus, there was an action “against the debtor” subject to the stay under § 362(a)(1). Id. In this sense, DeLisi was an atypical case because normally the beneficiary can demand payment from the issuing bank without instituting a quasi-judicial proceeding. The DeLisi court also remarked, however, that “recovery will be from the letter of credit and not from property of the debtor, at least initially.” Id. at 696 (emphasis added). Elsewhere, the court stated that it need not reach the question of whether the letter of credit is “property of the debtor or property held by the debtor.” Id. at 695. Is the court suggesting that the automatic stay might also apply to the Contract III payment because the payment constitutes “property of the estate”? If payment by the bank under Contract III is an
Sale V: Sight Draft with Negotiable Bill of Lading—On March 25, Seller in France and Buyer in Atlanta enter into a written contract for the sale of $500,000 worth of goods (Contract I). In the contract, Buyer obligates himself to procure a commercial letter of credit to be issued in Seller's favor for the $500,000 purchase price. Buyer approaches the bank and on April 4 they enter into a contract (Contract II) whereby the bank agrees to issue its irrevocable letter of credit in Seller-Beneficiary's favor. The letter will commit the bank to honor Seller-Beneficiary's sight draft for $500,000 upon presentation of a negotiable bill of lading and other specified documents. Buyer-Customer agrees to reimburse the bank for all payments made under the letter. As security for this obligation to reimburse the bank, Buyer gives the bank a security interest in all goods, documents and other contract rights involved in the transaction. The bank sends the required letter to Seller-Beneficiary on April 5. Seller receives the letter on April 9. On April 12, Seller ships the goods by boat in conformity with Contract I and presents the bank with its $500,000 sight draft, the requisite negotiable bill of lading and other documents on April 17. At this point the bank may do one of two things: i) Because the bank can legally defer honoring Seller's sight draft until the close of the third banking day after receiving the documents, it may contact Buyer at this time and demand Buyer to put it in funds before it honors Seller's draft; or ii) the bank may honor Seller's draft and then immediately seek reimbursement from Buyer. Assume that the bank adopts this latter course. It pays Seller's $500,000 sight draft on April 18, thereby making a demand loan to Buyer, and demands immediate reimbursement of that loan from Buyer. The bank has two claims for payment against Buyer although it can recover $500,000 only once. It has a subrogation claim against Buyer on Contract I and a separate reimbursement claim on Contract II. Buyer pays the bank on April 19 and receives in return the negotiable bill of lading covering the goods. On June 1, Buyer files a voluntary petition in bankruptcy.

Because this letter of credit transaction involves first, a payment from the bank to Seller and second, a reimbursement payment from Buyer to the bank, each of these payments must be analyzed in the light of possible preference attack.

initial step to payment by the bankrupt customer under Contract II, then the initial step may somehow involve "property of the debtor." The federal district court in Westinghouse, however, rejects any notion that the payment from bank to beneficiary under Contract III involves "property of the estate." Westinghouse Credit Corp. v. Page, No. 81-3172, slip op. at 3-4 (D.D.C. Mar. 30, 1982). Of course, the reimbursement payment from customer to bank would be subject to the automatic stay of § 362(a). Id. at 4. But it was to avoid such questions concerning the automatic stay that the author made the payments under Contracts III and II in each of the hypothetical sales occur before the bankruptcy of the customer.
a) The payment from the bank to Seller

In order to constitute a preferential transfer, there must be a transfer of the property of the bankrupt. The $500,000 paid by the bank to Seller on April 18 was a transfer of the bank’s assets, not Buyer’s assets. Viewed in isolation, therefore, it would seem impossible for Buyer’s trustee to challenge this commercial letter of credit payment on preference grounds. Research has revealed no case law dealing with this precise issue under prior bankruptcy law.\textsuperscript{94} Prior bankruptcy law, however, did treat payments made by guarantors or sureties of a bankrupt as transfers of assets of the guarantors or sureties, not as transfers of the assets of the bankrupt.\textsuperscript{95} Although a commercial letter of credit is not a guarantee, it is sufficiently analogous to permit reliance on these precedents.\textsuperscript{96}

*Aetna Business Credit, Inc. v. Hart Ski Manufacturing Co.*\textsuperscript{97}—a case decided under the new Bankruptcy Code—may inferentially support this conclusion. In *Hart Ski*, buyer Hart procured five commercial letters of credit from First National Bank of St. Paul to pay for skis purchased from a European seller. First National agreed to issue the letters of credit if Aetna Business Credit in turn would guarantee Hart’s repayment obligations. Aetna agreed to the guarantees only after Hart provided Aetna with collateral to secure repayment of its guarantees. Both the letters and the secured guarantees were issued on November 26. Hart filed for bankruptcy on February 13. During March, the month after Hart’s bankruptcy, First National was required to honor its letters. First National then obtained bankruptcy court approval to make timely demand on Hart and Aetna for reimbursement. At this point, Aetna brought a declaratory judgment action to determine its liability to First National on its guarantees.

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\textsuperscript{94} The author realizes that there are those who could take issue with this statement. Although the text of the opinion is unclear, it seems that the letters involved in *Twist Cap* may have been commercial letters of credit. After all, the beneficiaries of the letters, Alcoa and Central Can Company, appear to have been raw materials suppliers of *Twist Cap*. Commercial letters can be used to pay sellers in domestic sales transactions although they are more regularly used in international sales transactions. If the *Twist Cap* letters are commercial, then *Twist Cap* itself represents authority under prior bankruptcy law that bank-to-beneficiary payments can, on occasion, constitute the transfer of debtor’s assets. But the author has chosen to treat *Twist Cap* as a standby letter case and include it infra in Part III of this Article. My reasons are three. First, the text of the opinion itself is ambiguous with respect to the nature of the letters. Second, in legal circles, *Twist Cap* is generally discussed as a standby letter of credit case. Third, the *Twist Cap* judge relies on the earlier case of *Postal v. Smith (In re Marine Distrib., Inc.)* 522 F.2d 791 (9th Cir. 1975) (a standby letter case) to justify his holding.

\textsuperscript{95} *Westinghouse Credit Corp. v. Page*, No. 81-3172, slip op. at 3 n.3 (D.D.C. Mar. 30, 1982); see 4 Collier on Bankruptcy, *supra* note 50, ¶ 547.25, at 547-93.

\textsuperscript{96} Technically, however, a letter of credit is not a guarantee, see J. White & R. Summers, *supra* note 8, § 18-2, at 713.

\textsuperscript{97} 7 Bankr. 465 (Bankr. D. Minn. 1980).
The bankruptcy court permitted First National to recover against Aetna because Aetna's secured guarantees were not adjudged to be preferential transfers. What is significant in Hart Ski is that the bankruptcy court never questioned the propriety of First National's payment to the European seller. There was no hint in the opinion that the payment was made with anything other than First National's own money. Similarly, there was no hint in the opinion that the bank's payment to the European seller tainted its subsequent reimbursement claim against Aetna. Although it would have been difficult to retrieve the money from the European seller, the court might have questioned the propriety of the bank's reimbursement claim if it believed that the claim resulted from a preferential payment to the European seller.

b) The reimbursement payment from Buyer to the bank

If a voidable preference attack is leveled at commercial letter of credit payments, it should be leveled at Buyer's reimbursement payment to the bank. In Sale V, Buyer's $500,000 payment to the bank of April 19 is unquestionably the transfer of property of the bankrupt buyer to a creditor within ninety days of bankruptcy. It could even be viewed as a transfer for an antecedent debt because Buyer's debt to the bank was incurred prior to April 19.

Several persuasive arguments can be advanced, however, to immunize Buyer's April 19 payment to the bank from preference attack. The first two arguments depend on the bank's status as a secured purchase money lender. The third argument depends not on the bank's secured purchase money status as much as its ordinary secured status. The fourth and final argument relies on the section 547(c)(2) exemption for short-term credit payments.

The first argument offered to exempt the $500,000 reimbursement payment from preference attack derives from sections 2-505 and 2-506 of the UCC. As was shown in Sale IV, Seller's shipment of goods

98. Id. at 468.

99. Inferentially, the court in Hart Ski seems to have rejected another possible preference attack on First National's payment to the European seller. The bank did not have a security interest in Hart's assets but was protected by Aetna's secured guarantees. Aetna in turn did have a security interest in Hart's assets. Thus, although there would be three tiers of payments (bank to seller; Aetna to bank; estate of Hart to secured creditor Aetna), the end result would be that an unsecured seller would receive payment for the goods. Thus, the commercial letter of credit combined with the secured guarantees of Aetna resulted in substituting a secured creditor, Aetna, for an unsecured seller. This preference attack emphasizes the "end result" of the transaction. But, in inferentially rejecting this argument, the Hart Ski court seems correct. The end result of all tiers of the transaction is that the estate of Hart Ski received skis in return for an equivalent amount of assets.

100. See generally Miller v. Fisk Tire Co., 11 F.2d 301, 303-04 (D. Minn. 1926) (discussing the similar question of the guarantor's reimbursement claim).


102. See supra notes 74, 85-89 and accompanying text.
pursuant to a negotiable bill of lading reserves to Seller a perfected purchase money security interest in the goods. Under section 2-506, by paying Seller's sight draft and receiving the negotiable bill of lading, the bank is subrogated to Seller's rights under Contract I. Because Seller is secured, the bank falls heir to the secured status of Seller. Following the argument developed with respect to Sale IV, Buyer's payment to the bank, a perfected secured creditor, cannot constitute a preference.

The bank's second argument is also based on its status as a purchase money lender. But unlike the prior argument where the bank's purchase money status derives from that of Seller, here the bank will claim purchase money status in its own right. Section 547(c)(3) of the new Bankruptcy Code exempts from preference attack certain perfected purchase money security interests—whether or not they constitute transfers on account of an antecedent debt. Under the language of section 547(c)(3), there is no doubt that the bank has advanced "new value" to Buyer through its letter of credit commitment. There is also no doubt: (i) that this new value was given at or after the time the security agreement was signed on April 4, giving the bank a security interest in the goods and documents involved in the transaction; (ii) that this new value was given by the bank to enable Buyer to acquire property—here, the goods involved in the transaction and the negotiable document embodying them; and (iii) that this new value was used by the debtor to acquire this property. The commercial letter of credit suspended Buyer's obligation to pay for the goods and substituted in its place the payment obligation of the bank.

The most troubling requirement of the section 547(c)(3) exemption is contained in subsection (B). To gain the benefit of this exemption, the purchase money security interest must be perfected "before 10 days after such security interest attaches." 105

104. See supra notes 90-91 and accompanying text.
105. 11 U.S.C. § 547(c)(3) (Supp. IV 1980). Section 547(c)(3) reads in full: "The trustee may not avoid under this section a transfer—... (3) of a security interest in property acquired by the debtor—(A) to the extent such security interest secures new value that was—(i) given at or after the signing of a security agreement that contains a description of such property as collateral; (ii) given by or on behalf of the secured party under such agreement; (iii) given to enable the debtor to acquire such property; and (iv) in fact used by the debtor to acquire such property; and (B) that is perfected before 10 days after such security interest attaches." Id.
106. The Bankruptcy Code defines "new value" as "money or money's worth in goods, services, or new credit, or 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, but does not include an obligation substituted for an existing obligation." Id. § 547(a)(2). The words "new credit" in the definition cover letter of credit commitments.
107. See id. § 547(c)(3).
days after such security interest attaches.”¹⁰⁹ In Sale V, it is unclear exactly when the bank’s security interest attaches. Attachment takes place when the last of three events occurs—the giving of value, the signing of the security agreement and the debtor’s acquiring rights in the collateral.¹¹⁰ The security agreement was signed on April 4. Assuming, arguendo, that value was considered given on April 5, the day the letter of credit was “established” vis-à-vis Buyer,¹¹¹ then the security interest attached sometime on April 12 when Buyer acquired rights in the collateral. Because the collateral was the negotiable bill of lading, Buyer would acquire rights in the document when it was created at the time of shipment.¹¹² If the bank’s security interest attached on April 12, then the bank did perfect that interest “before 10 days after” the security interest attached. On April 18, the bank took possession of the negotiable document, thereby perfecting its purchase money security interest in the document.¹¹³

It would be unwise, however, for the bank to rely solely on possession to perfect its purchase money security interest. In Sale V, the bank did obtain possession of the negotiable bill of lading within ten days of attachment, but this possession was totally fortuitous. What if the bill of lading had been delayed in transit and arrived on April 24? Again, the bank would be lucky. Since the collateral constituted a negotiable document, the bank could rely for perfection on section 9-304(4) of the UCC. This subsection permits perfection of a security interest in a negotiable document for twenty-one days after attachment without either filing or possession.¹¹⁴ Thus on April 24, the

¹¹¹. In Sale V, there are three possible dates when the bank may have given “value” to the buyer: April 4, when Contract II was signed—the date when the bank agreed to issue the letter; April 5, the day the bank sent the letter to Seller and the letter became established vis-à-vis Buyer, see id. § 5-106(1)(a); and April 12, the day Seller received the letter and the letter became established vis-à-vis Seller. See id. § 5-106(1)(b). The author has chosen April 5 as the time when the bank gives value. It is true that on April 4, the bank promised to issue the letter and thus under § 1-201(44)(d), value appears to have been given Buyer. But until the letter is established vis-à-vis Buyer on April 5, the bank’s promise seems illusory. Until establishment, the bank could modify or revoke the terms of the letter without the consent of Buyer. “The time of the establishment of the letter of credit is related to the point of time at which the relationship of issuer [and] customer . . . would have a legal consequence.” Squillante, Letter of Credit: A Discourse (pt. 3), 84 Com. L.J. 474, 475 (1979); see Aetna Business Credit, Inc. v. Hart Ski Mfg. Co., 7 Bankr. 465, 468 (Bankr. D. Minn. 1980) (conclusion of law no. 14). April 12, the date the letter is established vis-à-vis Seller, does not appear relevant to when the bank becomes obligated to Buyer with respect to the letter, and thus to when the bank gives value to Buyer.
¹¹². A security interest cannot attach until the debtor has rights in the collateral. U.C.C. § 9-203 (1977).
¹¹³. A security interest in a negotiable document can be perfected by possession. Id. § 9-305.
¹¹⁴. Id. § 9-304(4).
bank could still argue that its purchase money security interest was perfected "before 10 days after" attachment on April 12. Suppose, however, the delay in the arrival of the bill of lading was longer, arriving on May 15. To protect itself against the dangers of delay and assure itself of the exemption in section 547(c)(3), the bank should file a financing statement covering the goods and the negotiable document either before or at the time it signs the April 4 security agreement—that is, Contract II. When the collateral is in another jurisdiction at the time of signing, section 9-103(1)(c) permits filing in Buyer’s state as to purchase money security interests in goods and arguably in negotiable documents.\textsuperscript{5} If the bank files on or before April 4, then whenever the last event of attachment occurs, the bank’s attached security interest will be simultaneously perfected. To be doubly safe, the bank might also file as to Buyer’s contract right to have Seller perform the contract—that is, identify and ship the goods. Contract rights are classified as general intangibles collateral under the UCC,\textsuperscript{1} and under section 9-103(3)(b) a security interest in general intangibles collateral may be perfected according to the law of the state of the debtor, here Buyer. As in Sale V, Contract II could be drafted to give the bank an interest in contract rights associated with the credit transaction.\textsuperscript{7} If the bank can claim an interest in this general intangibles collateral, it can then claim an interest in the subsequently

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\textsuperscript{5} Textually, § 9-103(1)(c) of the UCC covers the situation where the purchase money security interest is in goods. Because a negotiable document embodies the goods, however, it is clear that a purchase money security interest can be obtained in the document and, thus, in the goods. See 2 G. Gilmore, supra note 1, § 29.2, at 780. Consequently, it seems that § 9-103(1)(c) should apply to negotiable documents as well as to the underlying goods. Of course, § 9-103(1) applies generally to documents. See U.C.C. § 9-103(1) (1977).

\textsuperscript{1} U.C.C. § 9-106 (1977). The official comment to this section states that a "right to performance" is a general intangible. Id. § 9-106 official comment.

\textsuperscript{7} For a standard "Contract II," see Letters of Credit, supra note 15, at 333. Actually, "Contract II" is formally dubbed an "Application and Agreement for Commercial Letter of Credit." In clause 8 of this Application and Agreement, the collateral is described broadly as "all shipping documents . . . and other documents accompanying or relative to drafts drawn under the Credit and in and to any and all property shipped under or pursuant to or in connection with the Credit, or in any way relative thereto or to any of the drafts drawn thereunder (whether or not such documents, goods or other property be released to or upon the order of the undersigned on trust or bailee receipt), and in and to the proceeds of each and all of the foregoing." Id. at 336 (emphasis added). It is arguable whether this security agreement gives the bank a security interest in general intangibles involved in the transaction. The emphasized language seems broad enough to include the buyer’s right to due performance of the sales contract by the seller. If that language covers this contract right, then the security interest covers the documents that flow from shipment as "proceeds" of the contract right. But the parenthesized language in clause 8 seems to imply that the "other property" is tangible, otherwise how could it be released on "trust or bailee receipt"?
created negotiable bill of lading as the "proceeds" of this earlier intangibles collateral.\textsuperscript{118}

Again as in Sale IV, once the bank manages to immunize the creation of its purchase money security interest from preference attack, it logically follows that a payment satisfying that secured claim is also immunized from attack. Section 547(b)(5) requires that a preferential transfer leave the creditor in a better position than in a liquidation of Buyer's estate.\textsuperscript{119} Since the bank would have been paid as a secured creditor absent the April 19 payment, the April 19 payment was essentially neutral and not a preference.\textsuperscript{120}

The third argument against preference challenge hinges not on the bank's purchase money status but on its ordinary secured status. In the prior argument, it was critical for the bank to demonstrate that it was a purchase money lender because the section 547(c)(3) exemption applies only to such lenders.\textsuperscript{121} But the bank need not rely on an exemption from a rule unless the bank is subject to the rule. If the creation of the bank's security interest did not constitute a preferential transfer, reliance on the section 547(c)(3) exemption is unnecessary. The basic question then becomes: Does the bank's security interest fit within the Bankruptcy Code's definition of a preferential transfer? In Sale V, the creation of the bank's security interest clearly constitutes a transfer of Buyer's property to a creditor within ninety days of bankruptcy and presumably while Buyer was insolvent.\textsuperscript{122} But was the transfer for an antecedent debt? To determine whether the transfer was for an antecedent debt, three steps are necessary. First, the time when the debt from the bank to Buyer was created must be identified; second, the time when the security interest was transferred to the bank must be ascertained; and third the two times must be compared to determine if the debt arose prior to the transfer of the security interest. First, when was the debt created? Under bankruptcy law, a debt means liability on a claim and a claim means a right to payment whether matured, unmatured or contingent.\textsuperscript{123} It would seem then that the debt between the bank and Buyer was created on April 5, the day the letter was established between the two parties. It was then that the bank had a right to payment from Buyer for any moneys paid under the letter.

\textsuperscript{118} The UCC defines proceeds as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds" U.C.C. § 9-306(1) (1977). Here, the document would be what is received on the "other disposition" of the general intangible collateral—i.e., the right to shipment produces the negotiable document. A security interest in the collateral automatically gives you a security interest in the proceeds of that collateral. Id. § 9-306(2).
\textsuperscript{120} See supra notes 90-91 and accompanying text.
\textsuperscript{122} See supra note 76 for the definition of a "transfer" under the Bankruptcy Code.
\textsuperscript{123} See supra note 77 and accompanying text.
Second, when was the security interest transferred? This can be a complicated computation under bankruptcy law. A security interest does not attach until the last of three events occur—value must be given, here April 5, the security interest must be signed, here April 4, and the debtor must obtain rights in the collateral. The debtor cannot obtain rights in collateral before it exists. If the collateral is the negotiable bill of lading, then the debtor would acquire rights in the bill of lading when it was filled out by the carrier at the time of shipment of the goods on April 12. The bank's security interest would therefore attach to the bill on or about April 12. Under bankruptcy law a transfer cannot take place prior to attachment. Thus, assuming the debt was created on April 5, the earliest date for the transfer would be April 12, making the debt antedate the transfer by seven days. If the other necessary elements were present, the creation of the bank's security interest would constitute a preference since it was a transfer on account of an antecedent debt.

The bank, however, should not concede defeat too quickly. It could argue that the security agreement entitled the bank to a security interest not only in goods and documents but also in all contract rights stemming from the transaction. When Contract I was signed, the debtor-Buyer acquired rights to Seller's due performance. Pursuant to Contract II, the bank now has a security interest in this asset of Buyer. Unlike the negotiable bill, which did not exist until April 12, this intangible collateral came into existence on March 25, the date of Contract I, and thus was already in existence on April 4, the date the security agreement was signed. In this instance, the giving of value on April 5 was the last act necessary for attachment of the security interest. Thus, attachment and the creation of the debt both occurred on April 5. One further analytic step is necessary, however. Although a transfer cannot occur prior to attachment, it need not occur at the time of attachment. A transfer takes place on the day of attachment only when perfection of the security interest occurs within ten days of attachment. Because the bank can file as to general intangibles in the state of Buyer, it can easily perfect its security interest within ten days of attachment. Thus, the creation of the debt and the transfer of the security interest are contemporaneous and conse-

124. Under the Bankruptcy Code, a transfer cannot be made before the transfer "takes effect" between the transferor and transferee. 11 U.S.C. § 547(e)(2)(A) (Supp. IV 1980). This point when the transfer "takes effect" would have to be the point of "attachment."

125. A buyer obtains a right to the seller's performance—that is, due delivery of the goods—at the time the contract is agreed to. If this right to due performance becomes uncertain, § 2-609 of the UCC gives the buyer the right to demand an adequate assurance of due performance. U.C.C. § 2-609 (1977).


127. Id. § 547(e)(2)(A).

quently the transfer is not a preference. Even if successful, however, this argument might be a Pyrrhic victory. General intangibles collateral of this nature is short lived and when compared to the underlying goods and documents, fairly valueless. But the goods and documents can be viewed as “proceeds” of this earlier-created general intangibles collateral.\textsuperscript{129} Thus perfecting a security interest in Buyer’s contract rights against Seller may be more valuable than it first appears.

The bank’s fourth and final argument rests on the section 547(c)(2) exemption for transfers made “in payment of a debt incurred in the ordinary course of business . . . of the debtor [here Buyer] and the transferee [here the bank]” and “made not later than 45 days after such debt was incurred.”\textsuperscript{130} Assume that for the purposes of section 547(c)(2), a debt is considered “incurred” when “liability on a future claim arises.”\textsuperscript{131} In Sale V, the debt from Buyer to the bank was “incurred” on April 5 because on April 5 the letter of credit was “established” vis-à-vis Buyer. Once the letter is “established” vis-à-vis Buyer, Buyer’s liability to the bank for any payments made under the letter is set. Thus if the debt is “incurred” on April 5, Buyer’s reimbursement to the bank on April 19 would be within the forty-five day grace period and hence not a preferential transfer under section 547(c)(2).

One difficulty with this seemingly straight-forward analysis is the requirement that the transfer be in the ordinary course of business of both the bank and Buyer.\textsuperscript{132} To rely on this exemption, it would be helpful if the bank and Buyer could each show that letter of credit purchases were commonly used in their respective businesses.\textsuperscript{133}

Sale VI: Sight Draft with Nonnegotiable Bill of Lading\textsuperscript{134}—Seller in France and Buyer in Atlanta enter into the same basic transaction as that described in Sale V. The only differences are these: In Contract II, signed on April 4, the bank agrees to pay Seller’s sight draft for $500,000 upon the presentation to the bank of a non-negotiable (or straight) bill of lading naming Buyer as consignee. In Contract II, Buyer agrees to give the bank a security interest in the goods and contract rights (not the document) involved in the transaction. In all other particulars the transactions are the same.

With minor variations required by the different form of the transaction, the conclusions reached with respect to Sale V should apply to Sale VI as well.

\textsuperscript{129} See supra note 118 and accompanying text.
\textsuperscript{130} 11 U.S.C. § 547(c)(2) (Supp. IV 1980).
\textsuperscript{131} Tait & Williams, supra note 65, at 59.
\textsuperscript{132} 11 U.S.C. § 547(c)(2)(C) (Supp. IV 1980).
\textsuperscript{134} Most ocean bills of lading are negotiable. 1 G. Gilmore, supra note 1, § 1.4, at 17. Because some countries prohibit negotiable bills, however, nonnegotiable bills
a) *The payment from the bank to Seller-Beneficiary*

The bank's agreement to honor Seller's sight draft upon the presentation of a nonnegotiable, rather than a negotiable, bill of lading should not turn this payment into a voidable preference. In either case, the amount paid Seller is the bank's property, not Buyer's property.

b) *The reimbursement payment from Buyer to the bank*

In Sale VI, the bank might rely on either the section 547(c)(2) or section 547(c)(3) exemption in an effort to ward off trustee preference attack. Since the bank's section 547(c)(2) argument is essentially the same as that made in Sale V, the analysis here discusses only the argument based on the section 547(c)(3) purchase money exemption. By financing the sale, the bank becomes a purchase money lender. If it perfects its purchase money security interest in the underlying goods within ten days of signing the security agreement on April 4, it would also be a perfected purchase money lender. Thorny problems exist, however, with respect to perfection of the bank's security interest. Under the UCC, a security interest in goods in the possession of a bailee, such as a common carrier, other than one who has issued a negotiable document, is perfected in one of three ways. First the bank can have the bailee issue the nonnegotiable bill of lading in the bank's name. If that had been done, the bank's interest would have been perfected from the time of issue. In Sale VI, however, the nonnegotiable bill was not issued in the bank's name. Second, the bank could notify the carrier of the bank's security interest. Because the carrier in Sale VI may not be known to the bank, this might prove difficult. Third, the bank could file as to the goods. This seems the easiest method of perfection. Recall, though, that the goods are still in France on April 4—the day the security agreement is signed. Fortunately, section 9-103(1)(c) permits the bank as secured party to file a financing statement in Buyer's state in order to perfect its purchase money security interest in goods in another jurisdiction. Thus, as in Sale V, it does appear that section 547(c)(3) could immunize Buyer's reimbursement payment from preference attack—as long as the bank acquires a perfected purchase money security interest in the goods shipped.

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135. See supra notes 130-33 and accompanying text.


138. Id.

139. Id.

140. Id.

141. Id. § 9-103(1)(c).
One argument available to the bank in Sale V would not seem available in Sale VI. In Sale V, by shipping the goods under a negotiable bill of lading, Seller reserved a perfected purchase money security interest in the goods—a security interest to which the bank was subrogated upon payment of Seller’s draft. In Sale VI, however, Seller shipped under a nonnegotiable bill of lading naming Buyer as consignee. Although shipment under certain types of nonnegotiable bills of lading can have effects similar to shipment under a negotiable bill of lading, shipment under a nonnegotiable bill naming the buyer as a consignee is not one of them.

Sale VII: Time Draft with Negotiable Bill of Lading—On March 25, Seller in France and Buyer in Atlanta enter into a contract for the sale of $500,000 worth of goods (Contract I). In the contract, Buyer obligates himself to procure a commercial letter of credit to be issued in Seller’s favor for the $500,000 purchase price. Buyer and the bank conclude Contract II on April 4 whereby the bank agrees to issue its irrevocable letter of credit in Seller-Beneficiary’s favor. The letter commits the bank to accept Seller’s thirty-day time draft for $500,000 upon presentation of a negotiable bill of lading and other specified documents. Buyer-Customer agrees in Contract II to put the bank in effectively available funds not later than one day before the time draft matures. As security for his obligation to pay the bank the amount of Seller’s time draft, Buyer gives the bank a security interest in the goods, documents and contract rights involved in the transaction. The bank sends the letter of credit to Seller on April 5. Seller receives the letter on April 9 and on April 12, ships the goods by boat in conformity with Contract I. On April 17, Seller presents the bank with its $500,000 draft, payable thirty days after sight, the requisite negotiable bill of lading and other documents. On April 18, the bank stamps its acceptance on Seller’s draft and returns it to Seller through banking channels. The bank takes the negotiable bill of lading and delivers it to Buyer on April 19. On May 17, one day before maturity of the time draft, Buyer pays the bank the $500,000 necessary to pay Seller’s draft. The bank pays Seller’s draft on May 18. On June 1, Buyer files a voluntary petition in bankruptcy.

a) The payment from the bank to Seller-Beneficiary

In the discussion of this and subsequent sales, the basic analysis that the bank’s payment to Beneficiary is not a transfer of the assets of the bankrupt will not be repeated. That argument has been sufficiently developed in Sale V.

142. Id. § 2-505(1)(a).
143. Id. § 2-505(1)(b).
144. See supra notes 94-99 and accompanying text.
b) The reimbursement payment from Buyer to the bank

Several arguments can be presented to exempt Buyer's $500,000 payment to the bank from preference attack. In the main, however, they are variations of arguments made in Sale V above.

First, section 547(c)(2) exempts from preference treatment a transfer made in the ordinary course of business if the transfer is made within forty-five days of the date the debt was "incurred." As has been mentioned earlier in this Article, a debt is considered "incurred" for the purposes of section 547(c)(2) when the creditor does what is necessary to earn payment. In Sale VII, that would appear to be April 5—the day the letter of credit was established. On this day the bank's obligation to Buyer with respect to the letter became fully irrevocable. Thus Buyer's payment to the bank on May 17 would just fit within the forty-five day grace period.

In many transactions, however, it would be useless to rely on section 547(c)(2) to exempt time drafts from preference attack. It is quite common in international trade to use 60, 90 or 180 day payment terms. Obviously, the forty-five day grace period could not save these payments from preference attack. In these cases, the bank would better rely on its secured status inherited from Seller. As more fully discussed in Sale IV, Seller by shipping pursuant to a negotiable bill reserves a security interest in the goods shipped. By accepting the Seller's draft, the bank will succeed to these rights. Of course, once possession of the negotiable bill of lading has been released to Buyer, the bank will lose its perfected status after twenty-one days. But if the bank files as to the negotiable document within these twenty-one days, its perfection will continue uninterrupted. As long as it maintains its secured status, any payment to the bank to satisfy its perfected security interest should not constitute a preference.

In addition to its perfected status derived from Seller, the bank can also claim perfected status in its own right pursuant to section 547(c)(3). By agreeing in the letter of credit to accept Seller's draft on Buyer's behalf, the bank has in effect made an enabling loan to Buyer. Because value has been given, because a security agreement has been signed giving the bank a security interest in the negotiable document, goods, and contract rights involved in the transaction (Contract II),

146. See supra notes 65-66 and accompanying text.
147. See supra notes 38 & 111 and accompanying text.
148. Tait & Williams, supra note 65, at 65.
149. See supra 74 and accompanying text.
150. U.C.C. § 2-506(1) (1977). By accepting the time draft, the bank has "paid" the draft within the meaning of § 2-506. Id. § 2-506 official comment 2.
151. Id. § 9-304(5)(a).
152. Id. § 9-304(1),(6).
and because Buyer has acquired rights in the collateral at least at, if not before, the time of shipment, the purchase money security interest of the bank has attached.\textsuperscript{153} If the bank now perfects its security interest "before 10 days after [it] attaches,"\textsuperscript{154} the transfer to the bank of the purchase money security interest cannot constitute a preferential transfer of Buyer's property. To be sure that perfection occurs within the requisite time periods, the bank should file a financing statement covering the goods and negotiable documents either before or at the time the security agreement is signed.\textsuperscript{155} Filing should be according to the law of Buyer's state.\textsuperscript{156} Thus, when the bank releases the negotiable bill of lading to Buyer on April 19, the bank's perfected security interest in the document and goods will not be lost since perfection rests on filing, not on the bank's continued possession of the document. Consequently, payments made to the bank even sixty or ninety days after sight should not constitute preferential transfers because they were made to a perfected secured creditor with an invulnerable security interest.

If, however, the bank did not file, but instead relied on UCC sections 9-304(4) and 9-304(5) in order to perfect its security interest in the document, that perfected security interest would lapse twenty-one days after the negotiable document was released to the buyer.\textsuperscript{157} Payments made after this twenty-one day period, therefore, would be treated as payments made to an unperfected secured creditor and thus would be vulnerable to preference attack.

**Sale VIII: Time Draft with Nonnegotiable Bill of Lading—Seller in France and Buyer in Atlanta enter into the same basic transaction as that described in Sale VII. The only differences are these: In Contract II, signed on April 4, the bank agrees to accept Seller's thirty-day time draft for $500,000 upon presentation to the bank of a nonnegotiable (or straight) bill of lading naming Buyer as consignee. In Contract II, Buyer agrees to give the bank a security interest in the goods and contract rights (not the document) involved in the transaction. In all other particulars sales VII and VIII are the same.**

\textsuperscript{153} Id. § 9-203.


\textsuperscript{155} Section 9-402(1) of the UCC permits the financing statement to be filed before the security interest attaches. U.C.C. § 9-402(1) (1977); see Rapson, Prefiling UCC-1's: The Proper Procedure for Perfecting Security Interests, 14 U.C.C. L.J. 211, 212 (1982).

\textsuperscript{156} See U.C.C. § 9-103(1)(c) (1977).

\textsuperscript{157} Here the bank would have to "piggybank" the time periods of the two sections. Id. §§ 9-304(4), -304(5). Section 9-304(4) would give the bank a perfected security interest in the negotiable document for 21 days after the security interest attaches. If, during this 21 day period, the bank obtains possession of the negotiable document, then the bank has perfected its security interest by possession. Without a break in continuity, the time periods can be added together and the bank, if it then gives up possession of the document to Buyer, would get another 21 days of perfection. Id. § 9-304(5).
As in Sale VII, the bank may try to rely on section 547(c)(2) to exempt the May 17 payment from preference challenge. If the credit instrument is a thirty-day draft, then the bank will be successful in its argument. If the date the debt was "incurred" is considered to be April 5—the date the letter of credit was established—then the May 17 payment is within forty-five days of April 5. Again assuming the bank regularly issues letters of credit and Buyer regularly utilizes them to pay for goods purchased, the debt should be considered "incurred" in the ordinary course of their respective businesses.\(^{158}\)

But if in Sale VIII the time draft were payable 60, 90 or 120 days after sight, the bank's argument would have to rest on the section 547(c)(3) exemption for perfected purchase money security interests. If section 547(c)(3) exempts the bank's security interest from preference challenge, then there is no danger that a pre-bankruptcy payment satisfying that interest will be considered preferential. As has been mentioned earlier, the bank can rely on section 547(c)(3) only when it has a purchase money security interest and when it has perfected that purchase money security interest "before 10 days after such security interest attaches."\(^{159}\) There should be little doubt that the bank is a purchase money lender. Because the bill of lading called for in the contract was nonnegotiable, the bank wisely took a purchase money security interest in the goods, not the document, purchased with its letter of credit commitment.\(^{160}\) As for perfection, the bank should file a financing statement as to the goods in Buyer's state no later than April 4, the day the bank and Buyer signed the security agreement (Contract II).\(^ {161}\) If this is done, the bank's purchase money security interest will be perfected at the time of attachment, satisfying the section 547(c)(3)(B) ten-day requirement. Thus Buyer's May 17 payment to the secured bank would not be preferential.

Finally, as an alternative argument, if the nonnegotiable bill of lading named Seller rather than Buyer as consignee, the bank would be able to claim perfected purchase money status as successor in interest to Seller under sections 2-505(1)(b) and 2-506 of the UCC. This argument was fully developed in Sales IV and V.\(^ {162}\)

Sale IX: Setoff Created Within Ninety Days of Bankruptcy—On March 25, Seller in France and Buyer in Atlanta enter into a written contract for the sale of $500,000 worth of goods (Contract

\( ^{158}\) See supra 132-33 and accompanying text.


\(^ {160}\) A security interest in goods cannot be obtained by taking possession or filing as to a nonnegotiable document. The reason is simple. The nonnegotiable document does not "lock up" the goods—the security interest must thus be in the goods, not in the document. U.C.C. § 9-304(3) & official comment 3 (1977).

\(^ {161}\) Id. § 9-103(1)(c). The bank may pre-file before the security interest attaches. Id. § 9-402(1). Thus, when the security interest attaches, it will also be perfected.

\(^ {162}\) See supra notes 73-92, 101-04 and accompanying text.
I. The contract obligates Buyer to procure a commercial letter of credit issued in Seller's favor for the $500,000 purchase price. Buyer approaches the bank and on April 4 they enter into a contract (Contract II) whereby the bank agrees to issue its irrevocable letter of credit in Seller-Beneficiary's favor. The letter commits the bank to honor Seller-Beneficiary's sight draft for $500,000 upon presentation of a bill of lading, invoice and other documents. But in Contract II Buyer agrees (a) to reimburse the bank for its payment to Seller, (b) to give the bank a security interest in various types of collateral to secure its reimbursement obligation, and (c) to open and maintain a $500,000 deposit account in the bank until the letter of credit has been paid and the bank fully reimbursed. The deposit agreement requires that all withdrawals must be authorized by the bank and in addition contains the following language: "bank may, at any time when due, set off and use funds in your account to pay any debt you may owe us." On April 5, Buyer opens the account and the bank mails the letter of credit to Seller. The letter is received by Seller on April 9. On April 12, Seller ships conforming goods by boat and presents the bank with its draft and the specified documents on April 18. The bank pays Seller $500,000 on April 19 and exercises its right of set off by debiting Buyer's account $500,000 on the next day, April 20. Buyer files a voluntary petition in bankruptcy on June 1.

When two mutual and mature debts exist, a bank normally has the right to set off the money it owes to its depositor against the money its depositor owes to it.\textsuperscript{163} The very existence of mutual debts ordinarily creates the right of setoff. In Sale IX, the bank's claim to setoff is strengthened by the prior consent of Buyer.\textsuperscript{164} Although it is true that the bank's debt to Buyer (the deposit) and Buyer's debt to the bank (the reimbursement obligation) are both matured on April 20, under the facts of Sale IX the bank will not be able to exercise its rights of setoff to satisfy Buyer's debt to it.

In Sale IX, at the bank's insistence, Buyer opened the deposit account on April 5—within ninety days of bankruptcy. A balance equal to the face amount of the letter had to be maintained in the account and withdrawals could be made only with the permission of the bank. The creation and maintenance of this account was for the sole purpose of guaranteeing the bank its right of setoff. To use the phrase of one court, there was a "Setup For Setoff."\textsuperscript{165} Section 553(a)(3) of the Code forbids setoff if the debt owed to the debtor by

\begin{footnotes}
\item \textsuperscript{163} See generally B. Clark, \textit{supra} note 35, ¶ 11.1 (analyzing the nature of bank setoff). The Bankruptcy Code, however, does not create a "new right of setoff where none exists under non bankruptcy law. It merely recognizes the existence of the doctrine of setoff . . . ." 4 Collier on Bankruptcy, \textit{supra} note 50, ¶ 553.02, at 553-59.
\item \textsuperscript{164} See B. Clark, \textit{supra} note 35, ¶ 11.1, at 11-3 (there is "no requirement of prior customer consent").
\item \textsuperscript{165} First Nat'l City Bank v. Herpel, 622 F.2d 725, 727 (5th Cir. 1980).
\end{footnotes}
the creditor—the debt created by the deposit account—was incurred within ninety days of bankruptcy while the debtor was insolvent and "for the purpose" of obtaining a right of setoff against the debtor. Clearly, a newly opened account is a debt "incurred." Since the account was opened on April 5, it was incurred within ninety days of bankruptcy. As for the insolvency requirement, section 553, like section 547, creates a rebuttable presumption that the debtor was insolvent during the ninety days preceding bankruptcy. The only requirement of section 553(a)(3) left to be satisfied is whether the debt, here the account, was incurred "for the purpose" of obtaining the right of setoff. As to whose "purpose" is referred to in section 553—the buyer-debtor's or the bank-creditor's—the commentators seem to agree that the requirement is met if the bank intended the account to provide it with a means of setoff. Thus, if the bank account was opened within ninety days of bankruptcy for the purpose of giving the bank setoff rights, the bank will not be able to rely on those rights to secure payment of its reimbursement claim against Buyer.

Sale X: Setoff Created More than Ninety Days Before bankruptcy—Posit the same facts as in Sale IX except that the bank does not require Buyer to keep an account with it. Buyer, however, happens to have a general account with the bank—opened more than ninety days before bankruptcy. Because Buyer deposits his business receipts in this account, it regularly has a balance of over

169. Id. § 553(a)(3)(C).
170. See 4 Collier on Bankruptcy, supra note 50, ¶ 553.15; Freeman, supra note 167 at 498.
171. See 4 Collier on Bankruptcy, supra note 50, ¶ 553.15, at 553-64; Freeman, supra note 167, at 497-98. The bank might try to avoid this result by taking a contractual security interest in the bank deposit and not exercising its independent right to setoff. The right to setoff does not depend on contract and thus is quite different from a consensual security interest. See B. Clark, supra note 35, ¶ 11.3, at 11-6. For appropriate language creating a security interest in a bank account, see Counsels Corner, 98 Banking L.J. 859 (1981). Consensual security interests in deposit accounts are excluded from the coverage of Article 9. U.C.C. § 9-104(1) (1977). Because the bank has its reimbursement claim secured by the bank account, it could argue that the validity of the arrangement should be tested by § 547 governing preferences, rather than § 553 governing setoffs. Since the transfer of a security interest within 90 days of bankruptcy may not constitute a preference regardless of motive, the bank might be able to avoid § 553 and "bootstrap" itself into secured status by this route. But if the bank would already have the right of setoff regardless of contract, the contractual security interest would give the bank no greater rights than it already had. As a consequence, the arrangement should still be treated basically as a setoff and not as a security interest. See generally B. Clark, supra note 35, ¶ 11.3 (discussing when a bank setoff can be viewed as a security interest).
$500,000. On April 20, the day after the bank pays Seller, the bank exercises its right of setoff and debits the $500,000 from Buyer's account.

In this situation, the bank could probably exercise its right of setoff and keep the $500,000. In order to exercise setoff the bank must show that the debts are both “mutual” and “mature” and that the exercise of its setoff rights does not violate section 553 of the bankruptcy Code.172 “Mutuality” means that the bank “must hold its claim against the mutual depositor-borrower in the same right and capacity in which the deposit account is held.”173 Here the bank holds its claim against Buyer in the same capacity as Buyer holds his claim against the bank on its account. It is important to note, however, that the account was not a special account but a general and unrestricted account. If Buyer had deposited his money in a special account as trustee, executor or attorney for a third party, then the “mutuality” requirement would not have been satisfied and the bank could not have exercised setoff.174 As for the “maturity” requirement, there is at least a plausible argument that the new bankruptcy Code no longer restricts setoff to “mature” debts.175 But assuming, arguendo, that “maturity” is still a prerequisite for setoff, the debt owed to Buyer by the bank and the debt owed to the bank by Buyer, the reimbursement obligation, were both mature on April 20, the day the bank exercised its right of setoff.

Merely satisfying the “mutuality” and “maturity” requirements, however, does not guarantee to the bank the right to setoff. The exercise of setoff must not violate any other requirements of section 553. Without more facts, the bank’s exercise of setoff in Sale X would seem permissible.176 Although the bank account was opened more than ninety days prior to bankruptcy, section 553(a)(3) could still be used to void an exercise of setoff within ninety days of bankruptcy to the extent that the bank account had been “built up” during this period with the intent of enlarging the bank’s setoff claim. Section

172. B. Clark, supra note 35, ¶¶ 11.5-.6.
174. See B. Clark, supra note 35, ¶ 11.6.
175. See Freeman, supra note 167, at 493.
176. In a case where the bank can exercise setoff, a question arises as to which claim—its subrogation claim or its reimbursement claim—is being set off against the deposit account. Under the new Bankruptcy Code, there is some question about whether a claim acquired by subrogation within 90 days of bankruptcy can be set off against a deposit. See 11 U.S.C. § 553(a)(2) (Supp. IV 1980); Freeman, supra note 167, at 496. But once a letter of credit is established, the bank is required to honor its payment obligation. Thus, when it pays the beneficiary’s draft, it does so under contractual compulsion. The claim to which the bank is subrogated was not purchased with a view to setoff. It would seem that such subrogated claims transferred within 90 days of bankruptcy should be able to be set off. See id.
553(a)(3) requires proof of a subjective intent to give the bank a greater recovery, however, and no such intent is posited in Sale X. Even without such a subjective intent, the bank's setoff can be voided to the extent that the bank's setoff claim on the date of its exercise, April 20, was larger than its setoff claim on the ninetieth day prior to Bankruptcy. This is the improvement in position test introduced by the new bankruptcy Code. Again it will be assumed that the bank's setoff claim on April 20 was no larger than its claim on the ninetieth day before bankruptcy.

Thus, in most situations, transfers pursuant to commercial letters of credit—whether they be transfers from the bank to the beneficiary or from the customer to the bank—should not be in danger of preference avoidance. The seller-beneficiary can argue that the money he received was the property of the bank, not the property of the bankrupt Buyer. In its turn, the bank can usually rely for reimbursement on its perfected purchase money status. Although each step in the analysis may be defensible, does the end result violate bankruptcy policy?

Without question, the commercial letter of credit substitutes a secured bank for a seller as the creditor of the bankrupt's estate. But in a simple cash sale as in Sale I, if the buyer pays the seller and simultaneously receives goods of equal value, there would be no preferential transfer even if the payment were made within ninety days of the buyer's bankruptcy. Why should the result be changed if the buyer utilizes a letter of credit to pay the seller? The commercial letter of credit merely structures an equivalent transaction for buyers and sellers separated by thousands of miles.

### III. STANDBY LETTER OF CREDIT PAYMENTS AS PREFERENTIAL TRANSFERS

Although there is virtually no case law dealing with commercial letter of credit payments as preferences, there is at least some case law dealing inferentially with standby letter of credit payments as preferences. If a standby letter payment is to be considered preferential, it must constitute "property of the debtor." In Postal v. Smith (In re

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178. Id. § 553(b).
179. Id.
180. See W. Ward & H. Harfield, Bank Credits and Acceptances 27 (4th ed. 1958). Ward and Harfield state: "A documentary commercial letter of credit is automatically self-securing because the opening bank's credit or funds are placed at the disposal of the beneficiary in exchange for negotiable shipping documents that convey control of the merchandise. For this reason the opening bank may be willing to issue such a letter of credit for a buyer to whom it would not willingly make a loan for an equivalent amount without security." Id.
Marine Distributors, Inc.), William Postal and Travers Laird agreed to sell certain assets of a partnership to Marine Distributors, Inc. (MDI), which subsequently became bankrupt. Part of the purchase price was paid in cash but the remainder was evidenced by promissory notes of MDI. To secure payment of these notes, United California Bank (UCB) at MDI's request issued standby letters of credit in Postal and Laird's favor. To obtain payment under the letters, Postal and Laird were required to draw a sight draft for the amount demanded and present it to UCB along with (i) a signed statement that he had not received payment from MDI within five business days of the due date of the notes and (ii) the promissory notes clearly endorsed to UCB. After the letters were issued, MDI filed a voluntary petition in bankruptcy and its trustee sought a restraining order preventing UCB from making payments under the letters. The district court granted the restraining order. When the notes came due after bankruptcy and were not paid, Postal and Laird presented their drafts and necessary papers to UCB. The bank, of course, refused to pay in compliance with the restraining order. On appeal, the Ninth Circuit ruled that because the money represented by the standby letters of credit was UCB's, and not the bankrupt's, a bankruptcy court did not have jurisdiction to restrain UCB from paying out its own money. If UCB's payments to Postal and Laird were not transfers of MDI's property, then the court's reasoning would seem to immunize standby letter payments from preference attack. In the case, however, the reimbursement payment from MDI, or one of its guarantors, to UCB was not at issue. The Ninth Circuit did note, however, that MDI's reimbursement obligation to UCB was unsecured. The net effect of the standby letter of credit in Marine Distributors was to substitute one unsecured creditor (UCB) for other unsecured creditors (Postal and Laird).

This was not the situation in Twist Cap., Inc. v. Southeast Bank. Here, Southeast Bank of Tampa and the plaintiff debtor first entered

182. 522 F.2d at 793.
183. Id. at 792.
184. Id. at 794-95.
185. Id. at 795.
186. 1 Bankr. 284 (Bankr. D. Fla. 1979). As has been mentioned earlier, see supra note 94, the author has consciously chosen to include Twist Cap in the discussion of standby letters, rather than in the discussion of commercial letters, even though the letters at issue in the case may have been commercial letters of credit. The Twist Cap holding was criticized by Senator DeConcini in 188 Cong. Rec. S15,174 (daily ed. Dec. 1, 1980) (statement of Sen. DeConcini). Many law firms are also of the opinion that the Twist Cap decision is incorrect. See LOCs and the "Twist Cap" problem, 1982 Standard & Poor's Creditweek (Jan. 25, 1982 Supp.). For a critical discussion of the Twist Cap decision, see Baird, supra note 14.
into an agreement that secured any moneys paid by the bank on the
debtor's behalf. The bank then issued several letters of credit to both
Alcoa and Central Can Company on the debtor's behalf. After the
letters had been issued, the debtor filed a petition under Chapter XI of
the then bankruptcy act and sought to restrain Southeast Bank from
honoring its outstanding letters. In converting a temporary restraining
order into a preliminary injunction, the Florida bankruptcy court
distinguished *Marine Distributors.*\(^{187}\) In that case, the moneys rep-
sented by the letters were not secured by bankrupt's property; here
they were. If the letters in *Twist Cap* were paid by Southeast Bank, it
would then assert a secured claim against bankrupt's property and
presumably recover. The end result of all this, the *Twist Cap* court
felt, would be that the payments from the bank to Alcoa and Central
Can would be permissible because they did not involve a transfer of
the bankrupt's property, and that the payment from the bankrupt to
Southeast Bank would be permissible because it was a payment to
satisfy a secured claim. Taken together, unsecured creditors, Alcoa
and Central Can, would receive payment of their debts—something
that "would amount to an impermissible preferential treatment of
. . . [the creditors] which is contrary to the scheme of Chapter XI and
would certainly be counterproductive to the debtor's efforts to obtain
rehabilitation."\(^ {188}\)

In order to analyze the issues posed by *Marine Distributors* and
*Twist Cap,* a series of illustrative transactions will be presented.
Because standby letters of credit are frequently used to guarantee loan
repayments, it is logical to use a basic loan transaction as the focus of
the analysis.

**Loan I: Unsecured Loan—** On February 1, X creditor lends B
debtor $500,000 on an unsecured basis. The loan is to be repaid in a
lump sum with 10% interest per annum on or before November 1
of that same year. On November 1, B fully repays the loan to X. On
December 1, B files for bankruptcy.

Under these facts, the November 1 payment from B to X is a
preferential transfer. It is a transfer of B's property to X creditor
within ninety days of bankruptcy, while B was presumed insolvent,
and for an antecedent debt. The antecedent debt was created on
February 1—the date of the loan. Finally, the transfer to X on No-
vember 1 would probably result in X's receiving more than he would
receive in a chapter 7 liquidation. It must be emphasized, however,
that in Loan I, X is an unsecured creditor.

**Loan II: Secured Loan—** Posit exactly the same facts as in Loan I
except that at the time of the loan on February 1, X and B sign a
security agreement granting X a security interest in certain tangible

\(^{187}\) 1 Bankr. at 285.
\(^{188}\) Id.
property owned by B, the value of which equals the $500,000 loan. On February 2, X files a financing statement perfecting his security interest in the tangible property.

Because X is a secured creditor whose security interest is invulnerable to attack by the trustee—in this case the security interest was created and perfected more than ninety days before bankruptcy—B's November 1 payment to X is not a preferential transfer. As the court of appeals stated in Barash v. Public Finance Corporation,189 "[p]ayments on secured claims do not diminish the estate, i.e., they do not enable a creditor to receive more than he would under the liquidation provisions of the Code."190

Loan III: Letter of Credit; Unsecured Creditor, Unsecured Bank—On February 1, X creditor loans B debtor $500,000 on an unsecured basis. The loan is to be repaid in a lump sum on or before November 1 with 10% interest per annum (Contract I). To guarantee repayment of the $500,000 principal and $37,500 of interest, B contracts with C Bank to issue a standby letter of credit in X's favor for the requisite amount (Contract II). C Bank issues the letter on the next day, February 2. The letter conditions payment upon X's presentation to the bank of his draft, a signed writing stating that B has failed to pay the amount due at maturity, and B's promissory note endorsed to C Bank (Contract III). Because B is a valued customer of C Bank, C Bank issues the letter on an unsecured basis. Similarly, the bank does not require B to maintain a compensating balance in a deposit account. B fails to repay the loan on November 1 and on November 5, X presents C Bank with his sight draft, written default statement, and B's note properly endorsed. On November 6, C Bank pays the beneficiary, X, $537,750 and on November 7, B files a voluntary petition in bankruptcy.

a) The payment from the bank to the beneficiary

Under the facts of Loan III, the payment from C Bank to X should be immune from preference attack. The money paid comes from C Bank's assets; the payment is the result of the irrevocable commitment the bank undertook when the letter of credit was "established." Thus, it cannot logically constitute a transfer of property of the bankrupt B.

What law exists on this question—both under prior and present bankruptcy law—supports the idea that the bank's standby letter of credit payment to the beneficiary constitutes a transfer of the bank's, not the bankrupt's assets. The leading case on this question under prior law was Postal v. Smith (In re Marine Distributors, Inc.).191

189. 658 F.2d 504 (7th Cir. 1981).
190. Id. at 511.
191. 522 F.2d 791 (9th Cir. 1975).
Here the Fifth Circuit permitted an unsecured bank to make standby letter payments to two unsecured creditors after the debtor's bankruptcy. In its opinion, the Fifth Circuit stated that the letters of credit represented "monies of the bank." 192 Similarly, in Berman v. Le Beau Inter-America, Inc., 193 a case dealing with an alleged fraudulent conveyance of bankrupt's property, the court held that amounts paid by a bank pursuant to a standby letter of credit could not constitute a fraudulent conveyance of bankrupt's property because the amounts paid were in fact the bank's property. 194 This reasoning would immunize bank letter of credit payments from preference as well as fraudulent conveyance attack because both of these challenges require a showing that the transfer was of the bankrupt's property.

In Fidelity Bank v. Lutheran Mutual Life Insurance Co., 195 the bank issued a standby letter of credit for $10,500 to guarantee that its customer would take up a five hundred thousand dollar commitment from X. The bank did not demand a security interest in the customer's property to guarantee repayment of the letter. Bankruptcy proceedings were brought against the customer and the loan to the customer was thus never made. The creditor demanded payment of the standby letter from the bank. The bank resisted payment, but neither the bank nor the trustee argued that paying the letter would somehow constitute a transfer of the customer's assets. In affirming the lower court's grant of summary judgment for the creditor, 196 the Tenth Circuit did not allude to any bankruptcy problem with respect to the payment.

These three cases, however, were all decided under prior law. Would this result—that standby letter payments do not constitute property of the bankrupt—still hold true under the new Bankruptcy Code? Remember that under prior law, even if the standby letter payment were held to be property of the bankrupt, this did not mean that the trustee could avoid the payment as a preference. The trustee still had to prove that the beneficiary of the payment had "reasonable cause" to believe that the customer-bankrupt was insolvent at the time of the payment. Under the new Code, however, the trustee is relieved of proving this "reasonable cause" requirement. Thus whether the standby letter payment constitutes property of the bank or property of

192. Id. at 795.
194. Id. at 160.
195. 465 F.2d 211 (10th Cir. 1972). In this regard, see also Allegaert v. Chemical Bank, 657 F.2d 495 (2d Cir. 1980). In reversing summary judgment by the district court, the Second Circuit questioned whether a check directed to be paid by the bankrupt to one creditor and then endorsed by that creditor to a second creditor of the bankrupt could really be considered to be a transfer of the bankrupt's funds. Id. at 509.
196. 465 F.2d at 215.
the bankrupt takes on added significance under the new Code. In a recent case decided under the new Bankruptcy Code, a federal district court in Washington, D.C. has ruled that the bank-beneficiary payment pursuant to a standby letter of credit represents a transfer of the bank's assets. In *Westinghouse Credit Corp. v. Page*,197 Westinghouse Credit Corporation (WCC) was a major creditor of Page Associates, a Washington, D.C. limited partnership, and Virginia Page, its sole general partner. WCC was secured by a deed of trust on certain of the partnership's real property and in addition was the beneficiary of a $500,000 standby letter of credit issued by First National Bank of Maryland on the debtors' behalf. In its turn, First National Bank took a security interest in assets of Page Associates and Virginia Page to secure the bank's exposure under the letter of credit. In December of 1981, however, Page Associates and Virginia Page filed voluntary petitions seeking relief under Chapter 11 of the Bankruptcy Code. Four days later, WCC presented the standby letter to First National Bank for payment. The debtors immediately sought injunctive relief to block the bank from honoring the letter. The bankruptcy court issued both a temporary restraining order and then a preliminary injunction.198 On appeal, however, the federal district court set aside the preliminary injunction.199 In the course of its opinion, the court noted:

[C]ashing the letter of credit will not divest the estate of property since neither the letter of credit nor its proceeds are property of the estate under the Bankruptcy Code. Section 541 of 11 U.S.C. defines property of the estate as "all legal or equitable interests of the debtor"... In issuing the letter of credit the Bank entered into an independent contractual obligation to pay WCC out of its own assets.200

In another recent decision, a bankruptcy court has, at least inferentially, reached the same conclusion as the district court in *Westinghouse Credit Corp. v. Page*. In *In re Pine Tree Electric Co.*,201 a preliminary injunction was sought by the debtor-bankrupt to enjoin the bank from honoring its irrevocable letter of credit. The bankruptcy court assumed jurisdiction over the case citing Title 28 of the United States Code:202 "To the extent that [beneficiary's] actions are on account of an alleged debt to it and [issuing bank's] honor of the Letter of Credit converts [issuing bank's] contingent claim against the

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198. Id. at 1-2.
199. Id. at 8.
200. Id. at 3-4.
202. Id. at 107 (citing 28 U.S.C. § 1471(b)-(c) (Supp. III 1979)).
debtor to an active claim against the estate, this matter is appropriately before this Court."  

Although the court granted the bankrupt debtor's motion for the preliminary injunction, there was no suggestion that paying the letter would constitute a transfer of debtor's assets. The grounds for the injunction were based solely on section 5-114(2)(b) of the UCC—a section that permits letter of credit payments to be enjoined in limited circumstances—for example, when the beneficiary presents the bank with forged or fraudulent documents or there is fraud in the transaction.

There is, however, some troubling dictum in a third case decided under the new Bankruptcy Code. In *In re Joe De Lisi Fruit Co.*, the bankrupt had posted a standby letter of credit as a surety bond to obtain a wholesale produce dealer's license. Any failure to pay a supplier gave rise to a claim on the letter of credit. Certain unpaid suppliers started a proceeding before the State Agriculture Department to try to recover on the bankrupt's standby letter of credit. The bankruptcy court held that this proceeding was brought "against the debtor" within the meaning of the automatic stay provision of section 362(a) of the Bankruptcy Code and consequently voided the proceeding before the Agriculture Department. In the course of its opinion, however, the court stated: "The action is against the debtor. The Department is correct that recovery will be from the letter of credit and not from property of the debtor, at least initially." The use of the word "initially" may suggest that the question of whether there is a transfer of property of the debtor hinges on the ultimate result of all transfers connected with the letter of credit. Thus in the view of the *De Lisi* court, the question of whether the Contract III payment constitutes a transfer of property of the debtor may be connected with the resulting claim of the bank against the customer under Contract II.

b) Claims of the bank against the customer

One thing should be obvious when dealing with standby letters of credit. If the bank has to honor its payment commitment, it usually means that the customer is experiencing financial difficulties. Indeed, in the facts of Loan III, the customer went bankrupt the day after the bank paid X's draft. Thus if the bank has to pay out on a standby letter, the bank will usually be forced to seek recovery from a trustee in bankruptcy. The success of the bank in its bout with the trustee will depend on the nature of its claims against the estate of the bankrupt. The bank has two possible claims against the customer's estate: First, by paying the beneficiary, the bank is subrogated to his rights under

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203. Id. at 107-08.
205. Id. at 696 (emphasis added).
Contract I, and second, by agreement with the customer under Contract II, the bank has its own independent reimbursement claim against the customer's estate. In Loan III, the bank's reimbursement claim under Contract II was unsecured, and X's Contract I claim to which the bank was subrogated was also unsecured. Thus, even though the bank's claims resulted from a letter of credit payment, there is no reason to treat the bank as anything other than an unsecured creditor.

i) Reimbursement claim

Reimbursement claims are permitted by the Bankruptcy Code, but in this case, the bank's reimbursement claim is unsecured. In arranging for the issuance of the letter, the bank did not bargain for the rights of a secured creditor. Presumably because of a larger than average fee or because of a special business relationship, the bank decided to rely on the general credit of its customer, B. Issuing a letter without taking collateral would be atypical. Banks usually demand a security interest in goods and documents in return for issuing a commercial letter, or in collateral of equivalent value in return for issuing a standby letter.

ii) Subrogation claim

Under the Bankruptcy Code, by paying X's claim the bank is subrogated to X's rights under Contract I. In Loan III, X's claim, however, was unsecured; thus the bank is subrogated on Contract I to the rights of an unsecured creditor. But the bank might try to argue that X's claim against B's estate is the equivalent of a secured claim and thus the bank should be deemed subrogated to the rights of a secured creditor. The bank would claim that but for the letter, X would have only made the loan to B on a secured basis. X's reliance on the letter in lieu of a security interest makes his Contract I claim the equivalent of a secured claim. It was to this "secured" claim that the bank was subrogated.

The bank's argument, however, is weak. First, X's claim was not in fact a secured claim. Textually, the Bankruptcy Code permits subrogation only to X's existing rights. Second, in the case of letter of credit payments, it makes little sense to permit the bank to "bootstrap" itself into secured status through subrogation when the bank never sought secured status in its own right. Subrogation is a creature of equity and should be permitted solely to further the ends of substantial justice. As

206. See supra notes 35-36 and accompanying text.
208. Id. § 509(a).
more fully explained in Loan VI, even if $X$ were secured, substantial justice may not be served by permitting an unsecured bank to be subrogated to $X$'s secured claim against the estate of $B$. The bank would never have relied on $X$'s secured status in planning its future relationship with $B$. $X$ could relinquish all of $B$'s collateral thereby destroying the value of secured status and still leave the bank obligated to $X$ on its letter of credit. Thus, the bank's subrogation rights would provide a weak foundation for a claim of secured status. Because the bank should not have relied on its subrogation rights, the bank may not be able to make a strong case for equitable subrogation. Thus in Loan III, the bank's payment to the beneficiary should be immune from preference attack because it represents a transfer of the bank's assets. The bank's resulting claim against the bankrupt's estate, however, is unsecured. Because the end result of all letter of credit payments in Loan III is to substitute one unsecured creditor (the bank) for another unsecured creditor (the beneficiary), the trustee will have little incentive to attempt to avoid the bank-beneficiary payment. In Loan III, there would be little reason for the trustee to prefer having $X$, rather than $C$ Bank as $B$'s unsecured creditor.

Loan IV: Letter of Credit; Unsecured Creditor, Secured Bank—Posit the same basic facts as in Loan III except that in Contract II, $C$ Bank requires $B$ to give a security interest in sufficient collateral to secure the bank's maximum exposure on the letter of credit. On February 2, $B$ and $C$ Bank sign Contract II in which $B$ gives $C$ Bank a security interest in sufficient inventory and equipment to secure the face amount of the letter. On that same day, $C$ Bank files a financing statement perfecting its security interest in the collateral. Events then occur as stated in Loan III.

a) The payment from the bank to the beneficiary

If viewed in isolation, this payment, like the payment from the bank to beneficiary in Loan III, should not constitute a preference because the property transferred is not that of the bankrupt. But as the Twist Cap and De Lisi Fruit cases suggest, any answer to this question may be affected by the status of the bank vis-à-vis the bankrupt customer after the bank has paid the letter.

b) Claims of the bank against the customer

To determine whether the bank should be able to recover against the estate of the bankrupt, each of the bank's two claims must again be analyzed.


210. Where there are many unsecured creditors, the trustee may affirmatively wish to have a single unsecured bank substituted in their place. See Bank-supported debt, 1982 Standard & Poor's Creditweek 1933, 1934 (Supp. No. 2).
i) Reimbursement claim

Here the bank required in Contract II that the customer provide it with a security interest in collateral at least equal to the face amount of the letter. Because the bank bargained for secured status, it should be permitted to recover as a secured creditor unless there are compelling reasons to the contrary.

ii) Subrogation claim

As in Loan III, X creditor, to whose claim the bank is subrogated, is unsecured. There is little doubt that X, absent the letter of credit, would either not have lent B the money, lent it on a secured basis or lent it at a much higher interest rate. The point is that X relied on the letter in lieu of taking a security interest in some of B's assets. Thus the bank is subrogated to X's claim, which could arguably be adjudged to be the functional equivalent of a secured claim. For the reasons developed in Loan III, however, this argument is not convincing. But unlike Loan III, the bank here has acquired secured status in its own right and thus need not rely on subrogational rights to recover from the trustee.

Based on Twist Cap, however, the trustee has a strong argument against permitting the bank to recover under the facts of Loan IV. Although each step of the analysis is defensible, the end result may not be justifiable. Although the bank's payment to X can be legitimately viewed as a payment of the bank's assets, and not of B's assets, and although the bank's secured claim against B can also be viewed as a legitimate secured claim, taken together, the argument results in X, an unsecured creditor, receiving a preferential payment within ninety days of bankruptcy. Thus, the standby letter of credit has been used to circumvent bankruptcy policy. B's estate has been depleted by the substitution of a secured creditor, the bank, for an unsecured creditor, X.

On closer analysis, however, the Twist Cap argument is not persuasive. Assume that the Twist Cap approach were the rule: Letter of credit payments will constitute preferences if they result in substituting a secured creditor for an unsecured creditor. X, B and C Bank, however, could still structure a transaction that produces the benefits of a letter of credit without violating anti-preference policy. Suppose that X, instead of lending the money directly to B, deposits the money in C Bank, on the condition that the bank make an independent loan of an equivalent amount of money to B. The bank, however, lends the

211. The issuing bank could create the benefits of secured status in a different way. The bank could demand that the customer provide it with a third-party guarantee. In other words, if the customer cannot pay its § 5-114(3) reimbursement obligation, the guarantor will. See Goodwin Bros. Leasing, Inc. v. Citizens Bank, 587 F.2d 730, 733-34 (5th Cir. 1979).
money to B on a secured basis, but promises to repay X regardless of whether B repays it. When B repays C Bank, there could not be a preferential transfer of B's funds because the transfer was to a secured creditor. What C Bank does with the money vis-à-vis X should be of no concern to B's trustee. How is B's estate hurt by the subsequent C Bank to X transfer? Because X could originally have lent to B on a secured basis, the funneling of X's unsecured loan through C Bank, a secured creditor, is at base an equivalent transaction. The funnel device is used simply to give X the repayment obligation of the financially more solvent bank. If by this method the parties can create the benefits of a letter of credit and still not technically violate preference law, why should not an alternate method of structuring the same deal be accepted without preference challenge? The fact that an acceptable dodge around Twist Cap exists casts doubt on the validity of its holding.

Loan V: Letter of Credit; Secured Creditor, Secured Bank—
Posit again the same facts as in Loan III, except that both X creditor and C Bank take security interests in different assets of the debtor to secure X creditor's loan and C Bank's exposure on the letter. Assume both perfect their respective security interests the day after they attach.

a) The payment from the bank to the beneficiary

In Loan V, the bank's payment to X pursuant to Contract III should not be characterized as preferential for two reasons. First, the payment is from the assets of the bank, not the assets of the bankrupt. Second, even if one assumes, arguendo, that the payment by the bank was essentially a payment from B's assets, the payment would still be made to X, a secured creditor, whose security interest was itself invulnerable to preference attack. The satisfaction of an invulnerable perfected security interest—from whatever source—does not constitute a preference. X would presumably be receiving only what he would receive in a chapter 7 liquidation.

b) Claims of the bank against the customer

Under the specific facts of Loan V, C Bank should be able to recover from B's estate.

212. In Westinghouse Credit Corp. v. Page, No. 81-3172 (D.D.C. Mar. 30, 1982), the federal district court stated the following with respect to Twist Cap: "In In re Twist Cap the Bankruptcy Court rested its ruling on the fact that the issuer of letters of credit held a security interest in property of the bankrupt. For the reasons expressed in the text we find that this fact should not bar payment of the letter of credit in this case." Id., slip op. at 3 n.3. Of course, the beneficiary of the letter in Westinghouse was also a secured creditor. Id., slip op. at 1. Hence the payment of the letter had the effect of substituting a secured bank for a secured beneficiary, thus raising the issues discussed in Loan V infra. The court in Westinghouse, however, did not discuss the issue of whether letter of credit payments could constitute preferences.
i) Reimbursement claim

Here, as in Loan IV, the bank bargained for secured status. Thus both the bank and the customer fully expected that in the event of bankruptcy the bank would receive a preference as a secured creditor.

ii) Subrogation claim

X is a secured creditor and thus the bank inherits secured status under Contract I by way of subrogation. Section 509(a) of the Bankruptcy Code and case law permit the bank to become subrogated to X's secured claim. In Pearlman v. Reliance Insurance Co.,213 the Supreme Court held that a surety who pays a claim is entitled to the collateral securing that claim as against a trustee in bankruptcy.214 In one sense, this appears to be the correct result. B agreed to give X a preference by making him secured. If the bank is substituted for X as the secured creditor, the substitution should not matter to B or to his trustee.

There is, however, one possible argument that the trustee could use against the bank's subrogated claim. If the collateral taken by X under Contract I or by C Bank under Contract II were different, the trustee might contend that the substitution of the bank for X could have harmful effects on B's estate. C Bank may have strengthened its position by subrogating itself to the rights of X with respect to more valuable collateral. Such problems of valuation of collateral are, however, beyond the scope of this Article. In Loan V, it is assumed that the respective collateral are of equal value. If the problem did arise, however, for the reasons suggested in Loan VI, it would seem that the bank might not be able to "improve its position" via the equitable remedy of subrogation.

Loan VI: Letter of Credit; Secured Creditor, Unsecured Bank—
Posit again the same basic facts as in Loan III except that X creditor requires B debtor to give him a security interest in assets of B equivalent to the face amount of the loan in addition to having the standby letter of credit issued in his favor. Assume that on February 1, X makes the secured loan to B and perfects his security interest in the described collateral on the next day. The standby letter is issued and events proceed as described in Loan III.

a) The payment from the bank to the beneficiary

Because X is a secured creditor, the bank's payment to X on the letter of credit should not be considered preferential. The reasons supporting this conclusion have already been stated in Loan V above.

214. Id. at 141-42.
b) Claims of the bank against the customer

i) Reimbursement claim

Here the bank decided not to bargain for secured status. For whatever financial or business reasons, the bank decided to rely on the net worth of its customer for security. Since it decided to be a general creditor, the bank can hardly expect to be treated as a secured creditor in bankruptcy.

ii) Subrogation claim

The bank will of course try to bootstrap itself into secured status by subrogating itself to X's secured claim. In this case, section 509(a) of the Bankruptcy Code would permit the bank to subrogate itself to X's secured rights. Although the Code does permit the bank to recover from the trustee by subrogation, this result may be questionable in situations where the bank's sole claim to secured status is based on subrogation. On the one hand, permitting the unsecured bank to improve its rights through subrogation seems defensible because the estate of the bankrupt is not hurt by the subrogation. The bankrupt gave secured status to X and is not damaged by the bank's replacing X. But on the other hand, subrogation is an equitable remedy that should be used to further justice. In Loan VI, there is nothing inequitable about refusing to subrogate the bank to X's secured claim. If the bank desired secured status in the event of B's bankruptcy, it had the opportunity to do so when it negotiated Contract II. It is unrealistic to argue that the bank deferred taking a security interest in Contract II, relying instead on its potential subrogation rights to X's secured claim in Contract I. Had the bank "guaranteed" B's debt to X, the bank could more easily make this argument. In a guarantee, if X relinquished any collateral, C Bank would be to that extent released from its guarantee. Thus C Bank could argue reliance with more justification. Either C Bank would be freed of its liability on the guarantee or it would fall heir to X's secured status. A standby letter of credit, however, is not the precise equivalent of a guarantee. The bank's


218. See infra notes 232-33 and accompanying text.
letter of credit liability to X would not be released if X were to compromise its secured status with respect to B.\textsuperscript{219} Thus if X were to give up his security interest, the bank would still be liable to X under its standby letter of credit commitment.

Loan VII: Letter of Credit; Unsecured Creditor, Bank with Right of Setoff Created Within Ninety Days of Bankruptcy—On February 1, X creditor loans B debtor $500,000 on an unsecured basis. The loan is to be repaid on April 1 at 10% interest per annum. In order to guarantee repayment of the loan, B requests C Bank to issue a standby letter of credit in X's favor for the principal plus interest. C Bank agrees to issue the letter only on condition that B open an account with C and maintain a minimum balance of $500,000 in the account as long as the letter remains outstanding. All withdrawals must be approved by C Bank. B agrees and C Bank issues its letter on February 2. The deposit account is opened on that day. The deposit agreement signed by B states: "Bank may, at any time when due, set off and use funds in your account to pay any debt you may owe us." B fails to repay X the $500,000 on the due date—April 1. X presents his draft and other necessary papers on April 3. C Bank pays X and exercises its right of setoff against B's account on that same day. B files for bankruptcy on April 4. B's trustee demands the $500,000 back from C Bank.

For the reasons developed in Sale IX, the bank's exercise of setoff would violate bankruptcy law.\textsuperscript{220} Since C Bank required B to open the account within ninety days of bankruptcy for the purpose of giving the bank a right of setoff, the arrangement is void under section 553(a)(3) of the Bankruptcy Code.\textsuperscript{221} Because the bank cannot exercise setoff and does not have any security interest in B's assets, C Bank is relegated to the status of an unsecured creditor on both its subrogation claim under Contract I and its reimbursement claim under Contract II. This presents the same basic fact pattern as in Loan III.

Loan VIII: Letter of Credit; Unsecured Creditor, Bank with Right of Setoff Created More Than Ninety Days Before Bankruptcy—Posit the same facts in Loan V except that the Bank did not require B to open a $500,000 bank account on February 2. B, however, regularly banks at C Bank and had opened an account there more than ninety days before bankruptcy. B normally keeps a balance in excess of $500,000 in the account. The deposit agreement signed by B states: "Bank may, at any time when due, set off and use funds in your account to pay any debt you may owe us." When the loan is not repaid on April 1, X presents his draft and other necessary papers to C Bank. C Bank pays X on April 3 and exercises its right of setoff against B's account on that same day. B files for bankruptcy on April 4.

\textsuperscript{219} See supra note 209 and accompanying text.
\textsuperscript{220} See supra notes 163-71 and accompanying text.
In this case, as in Sale X above, the bank should be able to exercise its right of setoff and keep the $500,000.\textsuperscript{222} As is required for a valid setoff, the debts are both "mutual" and "matured."\textsuperscript{223} The trustee could attack the setoff only if B's account had been artificially built up during the ninety days before bankruptcy or if the bank had improved its position between the ninetieth day before bankruptcy and the day it exercised setoff.\textsuperscript{224} For example, under section 553(a)(3) of the Bankruptcy Code,\textsuperscript{225} if the balance in B's account had been only $300,000 on March 15 but then was intentionally increased to $500,000 on April 3 for the purpose of enhancing the bank's setoff recovery, the trustee could void the setoff to the extent of the intentional "build up."\textsuperscript{226} Similarly if, regardless of intent, the bank's setoff claim improves between the ninetieth day before bankruptcy and the day it was exercised—here, April 3—the trustee can also void the setoff to the extent of the bank's improved position.\textsuperscript{227}

Loan IX: Posit the same facts as in Loan III except that when X creditor's unsecured loan to B debtor matures on November 1, B debtor repays the loan. C Bank's letter of credit will customarily expire a few days after the maturity day of the loan. Assume that the letter expires on November 6. B debtor files for bankruptcy on December 1. On January 15, B's trustee successfully avoids as a preferential transfer the November 1 payment to X creditor. X creditor now claims repayment from C Bank under C Bank's standby letter. C Bank refuses, claiming that its standby letter expired on November 6.

Loan IX presents a potentially serious problem for a beneficiary of a standby letter of credit. He may find that he is required to return his loan repayment at a time when the standby letter guaranteeing the repayment has expired. Although there are various solutions to the problem, many raise the same preference issues discussed earlier in this Article.

One solution would be to revive C Bank's liability on its letter of credit when the trustee avoids the loan repayment to the beneficiary. X. C Bank, however, would argue vehemently against this solution. It issued the standby letter on certain specified terms—one such term was the time of expiration of the letter. C Bank might be willing to issue a standby letter on B's behalf for six months but not for twelve

\textsuperscript{222} As mentioned earlier, the actual debt set off by the bank against the deposit would be the reimbursement debt owed the bank. See supra note 176. The subrogation debt might not be able to be set off against the deposit. See Freeman, supra note 167, at 496.

\textsuperscript{223} See supra notes 172-75 and accompanying text.

\textsuperscript{224} 11 U.S.C. § 553(b) (Supp. IV 1980).

\textsuperscript{225} Id. § 553(a)(3).

\textsuperscript{226} On "build up" in setoff, see Freeman, supra note 167, at 497-98.

\textsuperscript{227} See id. at 498-503 (discussion of the "improvement in position" test).
months. If it thought that its liability on a letter of credit could be revived after its expiration date, then C Bank might have either (i) made a more extensive credit check of its customer, (ii) charged a substantially higher fee or (iii) refused to issue the letter.

C Bank’s position with respect to “reviving” the standby letter liability seems to be justified. In the case of sureties, it is true that liability does “revive” when a trustee avoids a preferential payment.  

For example, in *In re Herman Cantor Corp.*, a bank lent money to the debtor—bankrupt secured by assets pledged by a third party. Within ninety days of bankruptcy, the debtor repaid the loan to the bank and the bank returned the pledge of the third-party’s assets.  

Although a surety and a standby letter serve similar functions, they are not identical. The standby letter of credit represents an independent obligation of the bank in no way contingent on the customer’s acts with respect to the beneficiary. Unlike a surety, a bank issuing a standby letter cannot use customer’s defenses on Contract I to justify not honoring its payment obligation on Contract III. Since the bank’s obligation is independent and specific—that is, the obligation will be honored only if certain conditions are met by a definite date—“reviving” the obligation because of subsequent events in Contract I would seem to violate this independence principle of Contract III.

A second solution would be to require C Bank to remain exposed on its standby letter for ninety days after the maturity date of the loan. If within that ninety days debtor B falls into bankruptcy, X could present the bank with its draft for the amount of the loan. The holding in *Foreign Venture Limited Partnership v. Chemical Bank* would permit X to seek recovery from the bank under a standby letter while still in possession of a payment disputed by a trustee. As a practical matter, however, this solution is unwieldy. When there are many creditors in X’s position, the trustee may not seek to avoid all of the loan repayments, yet each of the creditors would have to make a demand against the bank to protect himself. This would increase transaction costs for all concerned. To avoid this problem, the bank’s exposure on the letter would have to be increased beyond ninety days

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228. There is authority for the proposition that a guarantee is revived if the trustee in bankruptcy recovers a preferential payment from a creditor. *In re Herman Cantor Corp.*, 15 Bankr. 747, 750 (Bankr. E.D. Va. 1981); Annot., 56 A.L.R. 1363 (1928).


230. *Id.* at 748.

231. *Id.* at 749.

232. *Id.* at 749-50.

after the maturity on the loan. The trustee is not required to make his preference challenge within ninety days of bankruptcy. The bank would have to extend its exposure on the standby letter for the length of the statute of limitations, normally two years from the time the trustee is appointed—something a bank may not wish to do.\(^2\)

A third solution would be to require the trustee to seek recovery of the $500,000 from the bank, not from X. It might seem illogical to make C Bank jointly liable for the return of the amount B paid to X on November 1, but that is exactly what the Bankruptcy Code permits. Under section 547 of the Bankruptcy Code, a voidable transfer is defined as a transfer of the property of a debtor to or for the benefit of a creditor.\(^3\) Since the standby letter of C Bank is a “guarantee” of B debtor’s repayment obligation, as B pays off his loan to X, the payment also benefits C Bank by reducing its contingent liability. Thus the trustee could, if he wished, seek to recover the $500,000 from C Bank.\(^4\) While a plausible solution, there is unfortunately no way to require the trustee to seek recovery of the payment from the bank rather than from the creditor.

The fourth and final solution is, of course, to suggest that the payment to X on November 1 should emanate from C Bank not from B. C Bank would then have the problem of recovering from B. Essentially this would mean structuring every standby letter of credit as a commercial letter of credit—that is, X creditor will seek repayment of the loan from the bank initially and will not be first required to seek repayment from B debtor. If this technique is used, we have returned full circle to the problems discussed in this Article. Based on Twist Cap, the trustee may be able either to recover the money from X, or refuse to honor C Bank’s reimbursement claim. The most logical solution to the Loan IX problem leads one inevitably to the preference analysis discussed in the earlier model loans. To determine whether the trustee can avoid the transfer from C Bank to X or deny C Bank’s claim against B, it will be necessary to consider the status of both X and C Bank. If, for example, X is unsecured and C Bank secured, then the solution to the Loan IX problem requires an analysis of the preference problem discussed in Loan IV.

\(^{234}\) It could be less than two years from the appointment of the trustee, however. The Bankruptcy Code provides that the trustee may not bring an “avoidance action” “after the earlier of—(1) two years after the appointment of the trustee . . . and (2) the time the case is closed or dismissed.” 11 U.S.C. § 546(a) (Supp. IV 1980). Assuming the trustee brings his action within the applicable period of time, he then has one year from the avoidance to begin his recovery action. Id. § 550(e).

\(^{235}\) Id. § 547(b)(1).

\(^{236}\) See 4 Collier on Bankruptcy, supra note 50, ¶ 547.18; Pitts, Insider Guarantees and the Law of Preferences, 55 Bankruptcy L.J. 343, 345-46 (1981).
Letters of credit are devices that satisfy unique commercial needs. Commercial letters of credit have had a long and venerable history in international trade. For well over a century, they have provided a swift and sure method of payment for foreign sellers of goods. More recently, standby letters have demonstrated their usefulness as payment “guarantees” in various non-sales transactions. It was commercial lawyers, however, not bankruptcy lawyers, who first structured these devices. Quite naturally, letters of credit were not fashioned with bankruptcy policy uppermost in mind. But if a rule against preferential transfers is an integral part of bankruptcy policy, then it makes little sense to develop such a rule, only to sanction a “dodge” around it. The presence of a letter of credit should not legalize what otherwise would be a preferential transfer.

To accommodate both letter of credit and preference policy, the bank's payment to the beneficiary (Contract III) should be immunized from preference attack. The very hallmark of the letter of credit has been the irrevocable nature of this payment obligation. Because the bank's obligation is irrevocable, the letter of credit places the risk of customer insolvency on the bank, not on the beneficiary. To permit the trustee to avoid the bank’s payment as a preference essentially destroys the usefulness of the letter of credit. By avoiding the bank's payment, the risk of customer insolvency is placed back on the beneficiary.

If Contract III is immunized, preference challenge should focus exclusively on the bank’s subrogation claim against the customer (Contract I) and its reimbursement claim against the customer (Contract II). Depending on the nature of these bank claims, the payment from the customer to the bank may or may not constitute a preference. Unlike Contract III, there is no reason to afford Contracts I and II any special commercial protection. As long as the bank’s Contract III payment to the beneficiary is not subject to preference challenge, letter of credit policy is not harmed by applying preference law to subsequent bank-customer payments.

238. Id.