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A Letter Of Credit and The Bankruptcy Paradox: Will It Protect You? - Maybe!

By Matthew P. Gerdisch of *Kohner, Mann & Kailas, S.C.*

A letter of credit ("LC") can be a valuable tool in a trade creditor's arsenal to secure payment of an account and at the same time avoid a future bankruptcy preference claim. **However, creditors should beware**. They can on occasion find themselves in the middle of what we call the "payment from the debtor bankruptcy paradox."

With a properly drafted stand-by LC in hand, a trade creditor can recover payment on an account balance from the debtor's bank (or other entity that issued the LC), in the event the debtor does not timely pay the creditor (or, if the creditor is utilizing a commercial or documentary LC, the creditor can receive payment from the bank on the LC upon presentation of required documents even before the account comes due). It is uniformly recognized by bankruptcy courts that a payment to a creditor by the bank on the LC is not subject to preference attack in the debtor's later bankruptcy case because the payment did not come from the debtor. The payment came from the bank under the bank's independent obligation to pay the creditor under the terms of the LC.

> *"A Letter of Credit is an important tool … but … it has its limits… give consideration to other tools … properly managed, the creditor should have complete defenses to any future preference claim and can avoid the bankruptcy paradox."*

Now comes the paradox. Suppose the following: The creditor is the beneficiary of a stand-by LC that expires in six months. The bank issued the LC under the debtor's unsecured line of credit with the bank. The debtor's $100,000 account balance is delinquent and the creditor is about to draw on the LC. However, instead of payment under the LC, the debtor wires to the creditor $100,000 as full payment of the delinquent account. Eighty-nine days later (within the 90-day bankruptcy preference period), the debtor files a Chapter 7 bankruptcy petition. One year and 11 months later, the Chapter 7 bankruptcy trustee commences an adversary action against the creditor seeking the return of the $100,000 payment as a preference claim. (For the purposes of this discussion, we will assume that the creditor does not have an ordinary course of business defense or a traditional "new-value" defense to the preference claim.) If the creditor is required to return the $100,000 payment to the bankruptcy estate as a preference, the invoices paid with the $100,000 payment are once again unpaid and very delinquent. Unfortunately, the creditor can no longer draw on the LC because the LC expired a few months after the bankruptcy case was filed.

Therein lies the paradox—having the LC is **not an unconditional guarantee of payment** on unpaid invoices, IF the debtor pays the invoices and then goes into bankruptcy. There are, however, terms that can be added to a LC to help alleviate this trap, but generally must be addressed on a case-by-case basis when negotiating the terms of the LC. Be sure to obtain counsel from your bankruptcy lawyers to help develop your protections.

Nevertheless, with a slight change to the facts of our hypothetical, the creditor may have the opportunity to defend against the preference claim by asserting a type of "release of lien" new-value defense. Assume the same hypothetical as above except that the LC is issued by the bank under a line of credit that is secured by all of the debtor's assets (and the value of those assets equals or exceeds the amount owed to the bank, plus the amount of the LC). In this hypothetical, if the debtor had *not* paid the creditor, the creditor would have drawn on the LC, and then the bank's line of credit claim would have increased along with the bank's secured claim to the debtor's assets. But, because the debtor paid the creditor, the bank did *not* have to pay on the LC, and the bank's potentially larger secured claim did *not* increase. So, the payment by the debtor "saved" the debtor's estate from the increase in the bank's secured claim and that savings, arguably, was "new value" to the estate which should cancel out the preference claim. The same analysis could be applied where the bank is undersecured, but only to the extent that the bank is secured for the LC draw. This concept has been recognized by bankruptcy courts, but different bankruptcy courts can come to different conclusions, and so this "defense" cannot be guaranteed. Nevertheless, it should not be overlooked if a creditor is confronted with this scenario.

Of course, at the outset, had the creditor drawn on the LC instead of taking payment from the debtor, the creditor would not have faced the paradox and could have avoided the preference claim altogether. A LC is an important tool of a creditor manager's arsenal, but as noted above, it has its limits. If faced with a troubled account, a credit manager should give consideration to other tools, such as a requiring the debtor to make payments on a cash-in-advance basis via confirmed wire transfer. Although cash-in-advance payments come from the debtor, if properly managed, the creditor should have complete defenses to any future preference claim and can avoid the bankruptcy paradox and the intricacies and pitfalls of a LC.

This can be a very technical area of the law and consultation with sophisticated bankruptcy attorneys before going into a letter of credit arrangement or liquidation is a wise investment. THE INFORMATION CONTAINED IN THIS ARTICLE IS NOT PROVIDED AS LEGAL ADVICE. LEGAL ADVICE SHOULD BE SOUGHT AS TO ANY FACTUAL AND LEGAL ISSUE.

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