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Standby Letters of Credit in Bankruptcy

Douglas G. Baird†

When a bank issues a letter of credit, it makes a binding promise to the party to whom it sends the letter to honor that party's drafts¹ on it, when those drafts are accompanied by specified documents. Letters of credit traditionally have been used as a method of paying for goods in international sales. For example, if geographical distance or some other factor makes a seller of a piece of equipment uncertain of its buyer's payment, the seller may insist that the buyer's bank issue a letter of credit naming the seller as beneficiary. After it ships the goods, the seller can draw on the letter by presenting the bank with its draft and the documents specified in the letter, which usually include a negotiable document of title such as a bill of lading. The bank is obligated to honor the draft regardless of any defenses to payment the buyer may have.²

In recent years, however, letters of credit have been used primarily in a different way. Known as "guarantee" or "standby" letters of credit, they are drawn upon if the principal means of payment fails.³ For example, a seller might agree to defer payment until the buyer receives the goods, but insist that the buyer provide a standby letter of credit from the bank, in which the bank promises to honor drafts when accompanied by the seller's signed statement that the buyer has received the goods and has failed to

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¹ A draft is a writing signed by one party unconditionally ordering another to pay a sum certain to the order of a specified person or to the bearer of the writing. U.C.C. § 3-104. The party signing such a document is a "drawer" and the one to which the order is directed is a "drawee." Ordinarily, a drawee has no obligation to honor a draft on it. *Id.* § 3-409. A letter of credit binds the bank to honor drafts when the beneficiary of the letter satisfies its conditions. *Id.* § 5-114.

² Fraud in the letter-of-credit transaction itself may be a defense to payment, but otherwise the bank's obligation is absolute and independent of the transaction between the seller and the buyer. See text and notes at notes 17-19, 51-55 *infra*.

³ See generally Joseph, *Letters of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816, 818-19 (1977); Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 721-24 (1973).

pay for them.⁴ The bank receives a fee and usually acquires a security interest in the buyer's property in return for bearing the risk of the buyer's default, but the bank does not have to give cash unless default actually occurs. The seller extends credit to the buyer while the goods are in transit, but it can rely on the credit of the bank to ensure ultimate payment. The buyer is not obliged to pay until it receives the goods.

Taking various forms, standby letters of credit have become a standard feature of commercial transactions because the bank's commitment under the letter is designed to protect the letter's beneficiary from loss if the party with whom it has contracted defaults or becomes insolvent.⁵ A recent case, *Twist Cap, Inc. v. Southeast Bank*,⁶ suggests, however, that a bankruptcy judge can enjoin a bank from honoring a letter of credit after the buyer has filed a petition in bankruptcy, if the bank's obligation to honor the letter is secured by an interest in the buyer's property.⁷ In March 1978, Twist Cap entered into an agreement with the Southeast Bank to secure any money paid by the bank on Twist Cap's behalf. In December 1977, June 1978, and March 1979, the bank issued standby letters of credit for Twist Cap's account that named as beneficiaries two sellers to the company. In August 1979, Twist

⁴ Under letter-of-credit doctrine, the bank's obligation to honor the draft must be tied to the production of a document. Its obligation cannot be triggered by an external event, nor can it be put in the position of deciding whether the buyer has in fact defaulted. See *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank*, 493 F.2d 1285, 1286 (9th Cir. 1974).

⁵ The value of outstanding letters of credit runs in the billions of dollars. See Note, *Judicial Development of Letters of Credit Law: A Reappraisal*, 66 CORNELL L. REV. 144, 145 n.9. (1980) (citing *Second Meeting on the Condition of the Banking System: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 95th Cong., 2d Sess. 157 (1978)).

⁶ 1 Bankr. 284 (Bankr. D. Fla. 1979).

⁷ *Id.* at 285-86. This question arose infrequently before *Twist Cap*, perhaps because courts faced with the issue tended to find that they lacked the power to enjoin a transfer of money from one creditor to another, because such a transaction did not involve property that was in the debtor's possession. See *Postal v. Smith (In re Marine Distributors, Inc.)*, 522 F.2d 791, 795 (9th Cir. 1975). *Twist Cap* distinguished *Marine Distributors* on the ground that that case did not involve a bank with a security interest in the debtor's property. 1 Bankr. at 285. Under the new Bankruptcy Code, however, the question of the existence of the court's power is coextensive with the question of the appropriateness of its exercise. 28 U.S.C. § 1471 (Supp. III 1979). Bankruptcy courts have the power to issue such injunctions if they are necessary or appropriate to carry out the Code's provisions. 11 U.S.C. § 105(a) (Supp. III 1979); see *In re Larmer Estates, Inc.*, 5 Bankr. 328, 330-31 (Bankr. E.D.N.Y. 1980) (bankruptcy courts have power to enjoin enforcement of a state judgment against guarantors, but exercise of such power was not appropriate under facts of the case).

Cap filed a Chapter XI petition;⁸ soon thereafter it filed a complaint and obtained an order restraining the bank from honoring the letters. The court denied the sellers' motion to dismiss the complaint and enjoined the bank from honoring the letters of credit until it resolved on the merits the issue of whether honoring them was a voidable preference.

Before *Twist Cap* no court or commentator thought that the independent obligation of a bank to honor a seller's drafts would be affected by the nature or extent of the bank's ultimate rights against the buyer's estate. Now, however, the *Twist Cap* result threatens to deprive the standby letter of credit of its basic advantage—certainty of payment regardless of the intervening misfortune of the other party—because banks are typically unwilling to bear the risk of a buyer's default without a security interest in the buyer's property. The decision already has disrupted the practice of issuing commercial paper backed by a standby letter of credit.⁹ Standard & Poor's now refuses to rate commercial paper of this type,¹⁰ and as a result, transactions involving millions of dollars must be executed differently, in ways that are usually more elaborate and costly. These disruptions suggest that a thorough analysis of the law governing standby letters of credit in bankruptcy is in order.

Part I of this article describes the operation of letters of credit in greater detail, focusing on standby letter-of-credit transactions. Part II shows that a standby letter of credit is in principle indistinguishable from other financing devices that survive the filing of a bankruptcy petition and suggests that, as a matter of policy, standby letters of credit should be treated in the same way as their functional equivalents.

Parts III and IV examine the Bankruptcy Code to determine whether it treats standby letters of credit the same as their close

⁸ The case arose as an arrangement under Chapter XI of the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (found as amended at 11 U.S.C. §§ 1-1103 (1976)) (superseded 1978).

⁹ A brief note of caution to lawyers recently appeared in the "Counsel's Corner" column of *The Banking Law Journal*. See *Letter of Credit Collateral—A Spur to the Wary*, 98 BANKING L.J. 579 (1981).

¹⁰ Standard & Poor's rating of commercial paper is now based solely on the creditworthiness of the bank only when "(1) neither the commercial paper holders nor the bank are secured, (2) both the commercial paper holders and the bank are secured by the same collateral . . . , and (3) the commercial paper holders are secured, but the bank is unsecured." N. Baron, *Debt Supported by Irrevocable Letters of Credit, Irrevocable Commitments and Note Purchase Agreements* (press release issued by Standard & Poor's Corporation, June 1980) (on file with *The University of Chicago Law Review*).

analogues. Part III addresses the statutory question of whether a bankruptcy trustee can enjoin the bank from honoring its letter of credit, a question distinct from whether the bank can assert a security interest after it honors the letter. When the bank honors a letter of credit, it merely shifts claims against the debtor's estate from one creditor (the seller, the beneficiary of the letter of credit) to another creditor (itself). The enforceability of the bank's security interest affects the size of the debtor's estate, but the act of honoring the letter of credit does not. For this reason, I argue that honoring the letter is not a preferential transfer voidable by the bankruptcy trustee.

Part IV addresses the more difficult statutory questions: whether a bank that honors a letter of credit either within ninety days before the filing of the bankruptcy petition or at any time after the filing should have the status of a secured creditor when it asserts claims against the debtor's estate. I show that both questions ultimately turn on when the debtor transferred an interest in its property to the bank. One might argue that the transfer takes place only when the letter of credit is honored, because only then does the contingent claim of the bank against the debtor ripen into a certain one. State law provides, however, that the transfer occurs when the bank's security interest attaches and is perfected, events that typically occur well before the ninety-day preference period. I demonstrate that no specific provisions in the new Bankruptcy Code commend a departure from the traditional rule that federal bankruptcy law does not alter the structure of property rights under state law.

I. THE LETTER-OF-CREDIT TRANSACTION

A. Background

As recently as twenty years ago, letters of credit were used principally in international sales.¹¹ No seller willingly sends its goods across national borders unless it is confident it will be paid, because no seller welcomes the prospect of having its goods in the care of unknown parties in a foreign port, where finding a new buyer may be impossible and bringing a legal action extremely dif-

¹¹ For a brief history of the letter of credit, see Kozolchyk, *Letters of Credit*, in 9 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 5, at 3-5 (1979) (published in a separate fascicle as B. KOZOLCHYK, LETTERS OF CREDIT (1979)).

ficult. The letter of credit as we now know it arose in the middle of the nineteenth century in response to this problem.¹²

Although letter-of-credit transactions vary,¹³ their basic structure can be stated briefly. In a typical letter-of-credit transaction, a seller specifies that payment be made with a letter of credit in its favor. The buyer (known as the "customer" in the letter-of-credit transaction) contracts with the bank to issue the letter. The bank, knowing the creditworthiness of its customer, is willing to issue the letter for a small fee, typically some fraction of one per cent of the price of the goods.¹⁴ The bank sends the letter to the seller, promising to pay the full price of the goods when the seller presents it with a draft and the documents specified in the letter. These documents typically include a negotiable bill of lading.

This arrangement benefits all parties to the transaction. The seller can manufacture goods to the buyer's order, confident it will be paid regardless of what befalls the buyer, because it can rely on the bank's commitment. The buyer that secures the letter of credit is better off than if it had advanced cash to the seller, because it does not become liable for the price until a trustworthy party (the bank) has possession of a negotiable document of title. The bank, in turn, earns a fee for issuing the letter and exposes itself to only a small risk, because it can readily assess the creditworthiness of its customer and, as the holder of a negotiable bill of lading, it has a perfected security interest in the goods involved in the transaction.¹⁵

The linchpin of the letter-of-credit transaction is the unique legal relationship between the bank and the beneficiary.¹⁶ Unlike a

¹² *Id.* The modern commercial letter of credit should not be confused with the seventeenth-century letter of credit, under which the issuer promised to reimburse the payor, without a right of action by the payee against the payor. *See id.* at 4.

¹³ A common variation is to have the buyer's bank persuade another bank that is known to the seller to "confirm" its letter to the seller. A bank that confirms the letter is bound to honor it in the same way as the issuer. For a discussion of the common variations on the letter of credit, see H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 29-55 (5th ed. 1974).

¹⁴ *Id.* at 58.

¹⁵ *See* U.C.C. § 2-505; J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 18-1, at 707-08 (2d ed. 1980).

¹⁶ In their discussion of the legal relationship created by the letter of credit, Professors White and Summers note that a letter of credit is not like other devices creating legal obligations, but rather that

a letter of credit is a letter of credit. As Bishop Butler once said, "Everything is what it is and not another thing." Thus, when a beneficiary sues an issuer for refusal to honor drafts drawn pursuant to a letter of credit, his theory is not that of breach of contract,

guarantor, the bank is primarily liable whenever the beneficiary presents a draft and documents that conform to the letter.¹⁷ Unlike its counterpart in a third-party beneficiary contract, the bank may not invoke the defenses its customer might have on the underlying contract.¹⁸ Moreover, the status of a beneficiary of a letter of credit is radically different from that of a payee of a check, who has no right to compel payment from the drawee bank.¹⁹ In the letter-of-credit transaction, the beneficiary does have the right to compel payment, and once the letter of credit is issued, the customer is powerless to stop payment in the absence of fraud. This difference exists because a letter of credit, unlike a negotiable instrument such as a check, is a binding and irrevocable obligation of the bank itself, not of the customer who procured it. The legal relationship between bank and beneficiary is governed by special principles which, like the law merchant in an earlier era, are nearly uniform throughout the world.²⁰

B. The Standby Letter of Credit

The archetypal letter-of-credit transaction described above is the means by which the parties pay one another if the underlying transaction takes place as planned. Standby letters of credit, in contrast, are never drawn upon if the transaction runs smoothly. For example, a builder might require a developer to have a bank issue a letter of credit in its behalf to ensure payment if the developer defaults. Such a letter of credit might require that the bank honor the builder's draft when accompanied by an architect's certificate that the building was finished and a statement by the builder that it had not been paid. In this kind of transaction, the bank usually will issue the letter only if the developer gives it a security interest in some property to which the bank will have recourse if the letter is drawn upon. If all goes well, the builder never presents its draft because it has been paid on schedule by the developer. If the developer defaults, however, the builder is still assured payment under the letter of credit. The bank then must seek

nor does he sue "on a negotiable instrument." Rather, he sues "on a letter of credit." J. WHITE & R. SUMMERS, *supra* note 15, § 18-2, at 715 (footnotes omitted).

¹⁷ See *id.* § 18-2, at 714.

¹⁸ Bank of N.C. v. Rock Island Bank, 570 F.2d 202, 206 n.7 (7th Cir. 1978); H. HARFIELD, *supra* note 13, at 163-65.

¹⁹ See U.C.C. §§ 3-401, -409.

²⁰ See Kozolchik, *supra* note 11, at 4.

reimbursement from the developer or enforce its security interest.

The parties to this transaction might employ a standby letter of credit in a different way. The developer might want to ensure that any money it advances to the builder is used to build the building. The developer could require the builder to have its bank issue a letter of credit in the developer's favor. Such a letter might provide that the developer's draft, accompanied by its statement that the builder had defaulted on its obligations, would be honored by the bank. Unlike the negotiable document of title specified in the usual commercial letter-of-credit transaction, the documents in the standby letter-of-credit transaction have no intrinsic value. For this reason, the bank is likely to insist that the builder give it a security interest as a condition of the letter's issuance.

Standby letters of credit also are used in transactions involving sales of goods. A supplier of raw materials, for example, might prefer to have a letter of credit in its favor from the buyer's bank rather than a security interest in the goods. Alternatively, a buyer of manufactured goods might want to protect itself when it advances money to finance its seller's purchase of raw materials. Such a buyer risks more in the event of default than one who sells on credit, because the buyer cannot easily acquire a purchase money security interest²¹ in the raw materials its seller uses. As the beneficiary of a standby letter of credit issued by the seller's bank, however, the buyer obtains equivalent protection.

A business that wishes to raise money may issue commercial paper backed by a standby letter of credit. This type of transaction involves larger dollar amounts than other uses of letters of credit. The business's bank may be more willing to accept the risk of its customer's insolvency than will the buyers of commercial paper. The buyers, however, may be willing to extend cash to the business if they can rely on the bank to ensure repayment. The letter of credit makes it easy for all of the parties to allocate among themselves the risk of the business's failure. The business acquires the cash it needs, the bank lends its credit to the business without having to supply cash, and the buyers of commercial paper enjoy a relatively safe investment. As in the other letter-of-credit transactions, all parties directly involved benefit.²²

²¹ A purchase money security interest is a security interest taken or retained by a person who enables the debtor to acquire rights in the collateral. U.C.C. § 9-107. The holder of a purchase money security interest has priority over all other secured creditors. *Id.* § 9-312.

²² Standby letters of credit are also used in transactions involving industrial revenue

II. STANDBY LETTERS OF CREDIT AND THEIR EFFECT ON THIRD PARTIES

The benefits of standby letters of credit nonetheless may come at the expense of other parties. A standby letter of credit becomes important only when the contingency the beneficiary feared comes to pass. The hard times that precipitated the default by the bank's customer may culminate in bankruptcy proceedings in which other creditors are involved. The rights of these creditors, both secured and unsecured, may be affected by the letter-of-credit transactions.

Bankruptcy courts always scrutinize situations in which a creditor is paid in full instead of its pro rata share of the debtor's property.²³ Although ordinary security interests are immune from attack by the bankruptcy trustee,²⁴ the standby letter-of-credit transaction may seem to call for this kind of scrutiny, because the beneficiary of a standby letter of credit has no notice requirement to satisfy and is paid immediately in full in cash. Even secured creditors who have filed financing statements and thereby have given notice of their security interests must suffer automatic stays²⁵ and the possibility of cram downs.²⁶ In the standby letter-

bonds and the sale of investment tax credits. Although in a particular case the benefits derived by the parties from reallocating the risk through a letter-of-credit transaction may be unclear, we should assume that the parties would not complicate their transaction by bringing in a bank unless they thought they would benefit thereby, even after taking the bank's fee into account.

²³ See 2 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 45.2, at 1287 (1965); Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 *YALE L.J.* 1143, 1147 (1979).

²⁴ This discussion assumes that security interests in after-acquired property are not involved. These are given special treatment under the new Bankruptcy Code. See 11 U.S.C. § 547 (Supp. III 1979); note 68 *infra*.

²⁵ Under section 362 of the Bankruptcy Code, 11 U.S.C. § 362 (Supp. III 1979), when a debtor files under Chapter 11, a secured party is automatically prevented from repossessing or selling the debtor's property, actions it could take under state law. This stay will remain in effect if the trustee can show, among other things, that the secured party is "adequately protected." See Bernstein, *Commercial Lenders and the Bankruptcy Reform Act of 1978*, 60 *CHI. B. REC.* 336, 338-42 (1979).

²⁶ When a debtor corporation is reorganized, a secured creditor may be forced to exchange its security interest for its "indubitable equivalent" or give up its right to take possession of the collateral in exchange for a lien on the collateral to the extent of its "allowed amount." The power of the bankruptcy court to force the secured creditor to give up its rights under state law is called its "cram down" power. See 11 U.S.C. §§ 1111, 1129 (Supp. III 1979); Blum, *The "Fair and Equitable" Standard For Confirming Reorganizations Under the New Bankruptcy Code*, 54 *AM. BANKR. L.J.* 165 (1980); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 *AM. BANKR. L.J.* 133 (1979). For a general discussion of the new Chapter 11, see Trost, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code*, 34 *BUS. LAW.* 1309 (1979).

of-credit transaction, however, the burden of giving notice and the risks the secured creditor faces in bankruptcy are in fact borne by one of the parties to the transaction—the bank. In this part I examine whether this shifting of costs should make any difference that is relevant in terms of bankruptcy principles. I do this by comparing the standby letter-of-credit transaction with one that provides the same protection to the beneficiary and that clearly survives the trustee's attack in bankruptcy. This is the transaction in which the beneficiary obtains a security interest in the property of the debtor in its own right in addition to a standby letter of credit from the bank. I conclude that these transactions differ only because in the former, the bank, not the seller, extends credit to the debtor.

A. Letters of Credit as a Financing Device

The court in *Twist Cap* asserted that honoring a letter of credit after the debtor files for bankruptcy allows a general creditor to enjoy the benefits usually reserved for secured creditors.²⁷ The beneficiary, however, differs in a crucial respect from an ordinary general creditor in that it bargained for special treatment before the ninety-day preference period preceding the debtor's filing,²⁸ just as a party that secures its debt does. If the beneficiary's bargain is not to be enforced when the secured party's is, the two situations must be distinguished. To illustrate, I focus on a single fact situation involving the sale of a piece of equipment.

A seller owns a high-speed digital computer with a value of one million dollars, but it wishes to purchase another more suited to its current needs. It has found a buyer for its old computer, and (to keep the example simple) both parties want an outright sale. An important element of their bargain will be the method of payment. Cash payment, of course, would be simplest, but the buyer may not have the purchase price in cash, and its bank may not be willing to lend it that amount. For its part, the seller may be cash rich and have no immediate need to be paid in full. If it were willing to defer payment, the seller could, in principle, fully protect itself with a purchase money security interest in the computer. The seller then would have priority with respect to the computer

²⁷ *Twist Cap, Inc. v. Southeast Bank*, 1 Bankr. 284, 285 (Bankr. D. Fla. 1979).

²⁸ On the 90-day preference period, see part IV-A *infra*.

over all other creditors,²⁹ and its security interest could not be set aside by a trustee in bankruptcy if the buyer became insolvent.³⁰

In practice, however, this arrangement might leave the seller insufficiently protected. The computer might depreciate at a rate faster than the buyer's payments, making the right to repossess an imperfect protection. To protect itself, the seller might seek a security interest in other property of the buyer, but other secured parties might have priority over it. Moreover, although the bankruptcy petition does not destroy a secured creditor's rights, the automatic stay and cram down powers of the trustee can disrupt them.³¹ Because of these risks, the seller might seek additional protection by introducing a third party into the transaction.

A third party can decrease the seller's risks by cosigning the buyer's promissory note as a guarantor. If the third party who is willing to bear the risk that the buyer will default is a bank, however, it must issue a standby letter of credit rather than a guarantee.³² Before issuing such a letter, the bank usually requires its customer (the purchaser of the computer) to grant it a security interest in property to which it will have recourse if it is forced to pay on the letter and the customer is unwilling or unable to reimburse it.

Twist Cap raises the issue whether such a security interest should survive an attack by a trustee in bankruptcy under its powers to void preferences and postpetition transfers.³³ In resolving this question, it must be recognized that a well-advised bank can avoid the *Twist Cap* problem almost entirely by restructuring the transaction. In addition to retaining a security interest for itself, the bank can insist that the seller as well retain a security interest that it must assign to the bank if it draws on the letter. A formal

²⁹ See note 21 *supra*.

³⁰ The trustee's power to avoid transfers such as the giving of a security interest does not extend to transfers for contemporaneous consideration, but only to transfers for antecedent debts. 11 U.S.C. § 547(c) (Supp. III 1979).

³¹ These powers prevent the secured creditor from extricating itself from a deal that has soured, forcing it to pin its hopes of recovering its money on the uncertain fortunes of the rehabilitated debtor. See notes 25-26 *supra*.

³² Banks typically are not authorized to guarantee the obligations of others. See Lord, *The No-Guaranty Rule and the Standby Letter of Credit Controversy*, 96 BANKING L.J. 46 (1979). In some jurisdictions such acts are ultra vires. *E.g.*, *New Jersey Bank v. Palladino*, 77 N.J. 33, 39 n.2, 389 A.2d 454, 457 n.2 (1978) (interpreting N.J. STAT. ANN. § 17:9A-253 (West 1963)); see *Arnold & Bransilver, The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272, 281-83 (1978).

³³ *Twist Cap, Inc. v. Southeast Bank*, 1 Bankr. 284, 285 (Bankr. D. Fla. 1979). For these trustee's avoidance powers, see 11 U.S.C. §§ 547, 549 (Supp. III 1979).

assignment is not even necessary. Under principles of equitable subrogation that were expressly incorporated into the Bankruptcy Code,³⁴ the bank would step into the seller's shoes when it honored the letter and would be able to assert against the insolvent buyer whatever rights the seller had.³⁵

If the bank had no security interest in its own right, this transaction could not be attacked as a voidable preference or a postpetition transfer, because the assignment of a security interest between two creditors does not involve a "transfer" by or for the benefit of the debtor.³⁶ The bank should be in no worse a position if, in addition to being the assignee of the seller's security interest, it also held one of equal or lesser scope in its own right. Even after *Twist Cap*, the most cautious analysts still think that such transactions are safe from the trustee's attack.³⁷

Why should the bank that relies solely on its own security interest be treated differently from the bank that honors a standby letter of credit and asserts a security interest through the beneficiary? The security interest in the first transaction is no more "unearned" than the security interest in the second, because in both the bank bargained for its special rights. The bank could have charged more for issuing the letter and forgone the protection of a security interest; conversely, if some other bank had offered to issue the letter of credit for the same fee but did not insist on a security interest, the parties could have transacted with it. The parties gave the bank the security interest because both found it in their interest to do so. We therefore should focus not on whether the bank's advantage is "unearned," but rather on the narrower question of what costs this arrangement imposes on third parties.

³⁴ 11 U.S.C. § 509(a) (Supp. III 1979) provides that "[e]xcept as provided in subsections (b) and (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment."

³⁵ See *Mickelson v. Aetna Cas. & Sur. Co. (In re J.V. Gleason Co.)*, 452 F.2d 1219, 1222, 1224 (8th Cir. 1971) (surety equitably subrogated to rights of mechanic's lienors after paying their claim against debtor).

³⁶ Transfers of security interests do not create voidable preference problems because they do not affect the rights of other creditors. See text and note at note 55 *infra*. Some courts have suggested recently, however, that an assignee's rights on reorganization may differ from the assignor's. *E.g.*, *Drubner v. Gaslight Village, Inc.*, 8 Bankr. 866, 871 (Bankr. D. Conn. 1981).

³⁷ See N. Baron, *supra* note 10.

B. Third-Party Costs of the Bank's Security Interest

As others have noted,³⁸ security interests impose costs on third parties. These costs alone, however, do not justify setting aside a security interest. The survival in bankruptcy of security interests perfected before the debtor became insolvent has been a feature of American bankruptcy law throughout this century. Congress carefully evaluated the balance between secured and general creditors in bankruptcy when it enacted the Code in 1978, and it preserved the principle that security interests entered into for contemporaneous consideration are not voidable preferences.³⁹

The proper inquiry must examine the unique benefits that the bank enjoys in a letter-of-credit transaction at the expense of other creditors when it asserts its own security interest in the debtor's property in addition to or instead of the beneficiary's security interest. The bank's security interest can differ from that usually asserted by a seller in two respects: the filing that perfects the interest and the priority that the bank consequently enjoys. These differences, however, stem from the parties' decision to have the bank, rather than the seller, bear the risk of the buyer's default. The bank's security interest does not resemble the typical security interest in that its obligation is contingent, but no principle of bankruptcy justifies treating the bank worse than if its extension of credit to the buyer had not been contingent. Indeed, the Bankruptcy Code, both in its treatment of contingent claims against a debtor's estate⁴⁰ and in its express indorsement of subrogation rights,⁴¹ suggests that contingent claims are to be treated in the same way as fixed claims. A closer examination of the differences in filing and priority makes this conclusion clear.

1. *Filing Differences.* When the bank protects itself through the seller's security interest, a creditor considering a loan to the debtor can find the seller's name in the filing system. In contrast, if the bank enjoys the security interest directly, the seller's name will not appear on the financing statement at all. In fact, if the debtor's bank already has made a secured loan to him, the bank's original

³⁸ See Schwartz, *Security Interests and Bankruptcy Priorities: A Review of the Current Theories*, 10 J. LEGAL STUD. 1, 2 (1981).

³⁹ See 4 COLLIER ON BANKRUPTCY ¶ 547.20, at 547-71 to -73 (15th ed. 1981).

⁴⁰ 11 U.S.C. § 101(4)(A) (Supp. III 1979) provides that "claim" means the "right to payment, whether or not such a right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."

⁴¹ See *id.* § 509(a); text and note at note 34 *supra*; text at note 65 *infra*.

filing may have been broad enough to encompass the new security interest without a new filing.⁴² One may doubt, however, that the absence of the seller's name in the financing statement affects third parties any differently than the absence of much other information in a notice filing system.

In a filing system like that of Article 9 of the Uniform Commercial Code, a financing statement conveys to the potential creditor only enough information to put it on notice that property of the debtor may be encumbered.⁴³ If a creditor found that a bank had a first-priority security interest in all of a debtor's property, it would know to ask the debtor to reveal all of its dealings with the bank. It also could ask the debtor to have the bank verify a list of all the claims its security interest presently secured.⁴⁴ The bank's contingent liability on the letter of credit would appear on such a list.⁴⁵ The information available to the potential creditor about this transaction is not different from that available about all others between the bank and the debtor. In fact, if a bank issues standby letters of credit to several different sellers on behalf of one debtor, other creditors may be better off than they would be if each seller had obtained a security interest in its own right. In the former case, the potential creditors need to require the debtor to have the bank verify one list, whereas in the latter case, they must ask the debtor to have each of the sellers verify a different list. Nothing in the filing requirements mandates treating contingent claims differently from fixed ones.

⁴² For example, the financing statement may indicate simply that the collateral consists of "all personal property of the debtor, now existing or hereafter acquired." The bank's subsequent agreement to secure the issuance of a standby letter of credit does not require a new filing. U.C.C. § 9-312. *But see* *Coin-O-Matic Serv. Co. v. Rhode Island Hosp. Trust Co.*, 3 U.C.C. REP. 1112, 1120 (R.I. Super. Ct. 1966) (applying the 1962 version of the U.C.C.).

⁴³ U.C.C. § 9-402(1) provides that:

A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral.

For a general discussion of notice filing, see 1 G. GILMORE, *supra* note 23, §§ 15.1-3. Note that requiring the listing of the secured party's name and address does not give a potential creditor any right to obtain information from the secured party directly. *See id.* § 15.3, at 472. As Professor Gilmore notes, "[t]here is no reason why a secured party should be put to the cost and burden of preparing detailed statements of his affairs to satisfy the curiosity of officious intermeddlers, business competitors or the student editors of law reviews." *Id.*

⁴⁴ U.C.C. § 9-208.

⁴⁵ The bank's failure to include the contingent liability would deprive it of the right to enforce the security interest against persons misled by its failure to comply. *Id.* § 9-208(2).

2. *Priority Differences.* Of perhaps greater significance is the priority position of the bank. If the bank already has a security interest in the debtor's property, the priority of its new security interest arising from the letter-of-credit transaction may relate back to the date of the filing of the bank's original financing statement, if the property being used as collateral is covered by the original statement's description.⁴⁶ If the seller had not dealt with the buyer previously and created its own security interest, it would have a first priority only to the extent of its purchase money security interest. For all other property, the seller's security interest would be subordinate to all those filed previously.⁴⁷ Thus, by having dealt with the debtor before, the bank might enjoy a higher priority, at the expense of third parties, than it would if the seller had obtained the security interest in its own right and assigned it to the bank.⁴⁸

This favorable position, however, does not stem from the fact that the bank used a letter of credit to cover the risk of the buyer's insolvency. Such a commitment does not differ in principle from a loan of money to the buyer to pay for the seller's goods. The bank bears the same default risk in both transactions. In both cases, the bank is better positioned than other creditors. Because it has dealt with the debtor previously, the bank finds it easier to evaluate the credit risk. Because of the first-to-file rule, the bank's debt will be better secured than later creditors' debts.⁴⁹ Although these advantages make this bank more willing to issue the letter of credit than a bank that has not dealt with the debtor previously, this willingness does not arise from any features unique to the letter of credit. The bank would enjoy these advantages regardless of the structure of the transaction.

⁴⁶ The priority of a security interest depends not on when the security interest attached or was perfected, but on when the financing statement was filed. This is known as the "first-to-file" rule. *Id.* § 9-312(5).

⁴⁷ This is also a result of the first-to-file rule.

⁴⁸ The bank's priority extends only as far as its original filing gave notice of its security interest. U.C.C. § 9-204(3). At the time of the filing, the debtor need not have owned the particular piece of property in which the bank's security interest is later asserted, as long as the financing statement contained an after-acquired property clause. *See id.* §§ 9-204, -312(7). Even with an after-acquired property clause, however, the bank usually will not enjoy priority over later purchase money lenders. *See id.* § 9-312(2)-(4). Thus, it is possible that, if the seller has a purchase money security interest, the bank would be better off asserting the seller's security interest (as it clearly can) than its own.

⁴⁹ On the principles underlying the Code's priority rules, see Jackson & Kronman, *supra* note 23, at 1167-75.

In summary, the bank with a security interest in the debtor's property in a standby letter-of-credit transaction gains no advantages at the expense of other creditors that are attributable to the use of the letter of credit. Because the bank has no priority over others when it honors the letter of credit unless it has validly filed under Article 9, creditors cannot complain of inadequate notice.⁵⁰ Notice in the case of a standby letter of credit is as effective as it is in any other context. Similarly, the nature of the letter-of-credit transaction does not provoke the objection that the transaction may give the bank a better priority position than if the seller established its own security interest and transferred it to the bank. In the standby letter-of-credit transaction, the bank—not the seller—bears the risk of the debtor's insolvency. Consequently, the rights of the seller should not determine the rights of the bank. Rather, the bank's priority position should be no different from that it would have enjoyed had it simply made a loan to the buyer directly.

III. THE TRUSTEE'S POWER TO ENJOIN PAYMENT

The conclusion that standby letters of credit in principle should survive in bankruptcy does not answer the more fundamental statutory question: whether the new Bankruptcy Code gives the bankruptcy trustee the power to enjoin payment of drafts under letters of credit and to avoid security interests that arise in letter-of-credit transactions. This part examines the trustee's authority under the Code to enjoin payment; part IV will explore its power to avoid the bank's security interest.

Even if one were to conclude that a bank that had honored a letter of credit could not successfully assert a security interest in the debtor's property, it does not follow that the honoring of a letter of credit should be enjoined.⁵¹ It is axiomatic that letters of credit represent obligations of the bank completely independent of the underlying transaction.⁵² Outside of bankruptcy, courts enjoin payment on letters of credit only when there is outright fraud in

⁵⁰ This is true of the secured creditor's rights in bankruptcy. Outside of bankruptcy a secured creditor prevails over a general creditor even if it has failed to file. U.C.C. § 9-301.

⁵¹ See *Newport Bank v. Herkimer Bank*, 225 U.S. 178, 185-86 (1912) (distinguishing a guarantor's honoring of its obligation to a third party from the rights of the debtor's estate and the guarantor against one another; holding the former not a voidable preference, even though the third party was paid off in full).

⁵² See text and notes at notes 16-20 *supra*.

the letter-of-credit transaction itself.⁵³ Parties that bargain for a letter of credit assume that regardless of war, revolution, or other catastrophe, the letter will be honored when the documents specified in the letter are presented.⁵⁴ Under letter-of-credit doctrine, the beneficiary of the letter need not concern itself with how the customer induced the bank to issue the letter in the first instance. It need look no further than the bank's own trustworthiness.

General principles of bankruptcy reinforce the independence of the bank's obligation to honor drafts in a letter-of-credit transaction from its rights against its now insolvent customer. Even after a bankruptcy petition is filed, creditors remain free to transact among themselves. The bank's honoring of the letter of credit is such a transaction, because it benefits the seller at the expense of the bank without changing the size of the debtor's estate or affecting the claims of other creditors. It would not be a voidable preference under the old bankruptcy law, because the transfer does not diminish the fund to which creditors of the same class can resort for payment of their debts.⁵⁵

⁵³ See U.C.C. § 5-114(1) ("An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary."); *id.* § 5-114(2) (a court may enjoin honoring a letter of credit when documents are "forged or fraudulent or there is fraud in the transaction").

"Fraud in the transaction" might include a situation in which the documents describing a shipment of goods are facially in order, but the shipment consists of garbage. See, e.g., *Sztejn v. Schroder Banking Corp.*, 177 Misc. 719, 722, 31 N.Y.S.2d 631, 634-35 (Sup. Ct. 1941). "Fraud in the transaction" in the context of a standby letter of credit might include cases in which the beneficiary of the letter prepared a document that was fraudulent—for instance, one stating that another party was in default when it was not.

Whether there was fraud in the transaction is the most frequently litigated issue involving letters of credit. It was recently the focus of controversy in a case of standby letters of credit in favor of the government of Iran. See *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 15 n.3, 16 (2d Cir. 1979); Note, "Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution, 93 HARV. L. REV. 992 (1980). Throughout this article I assume that there has been no "fraud in the transaction" on the part of the seller and that an injunction under letter-of-credit doctrine is therefore inappropriate.

⁵⁴ See *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 16 (2d Cir. 1979) (Iranian revolution) ("There is nothing in the U.C.C. . . . which excuses an issuing bank from paying a letter of credit because of supervening illegality, impossibility, war or insurrection."). The Second Circuit in *KMW*, however, did find it had the equitable power to require the bank to give three days' notice to the customer before honoring the letter, so that the customer could determine whether the documents complied with the terms of the letter or were fraudulent. *Id.* at 17.

⁵⁵ See *Kapela v. Newman*, 649 F.2d 887, 892 (1st Cir. 1981); *Farmers Bank v. Julian*, 383 F.2d 314, 327 (8th Cir.), *cert. denied*, 389 U.S. 1021 (1967); *Walker v. Wilkinson*, 296 F. 850, 852 (5th Cir.), *cert. denied*, 265 U.S. 596 (1924); 3 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 60.20, at 859-60 (14th ed. 1977).

Nothing in the Code brings this well-established principle of bankruptcy into question. Section 362 of the Code provides that the filing of the bankruptcy petition automatically stays "any act to create, perfect, or enforce any lien against property of the estate."⁵⁶ If a bank's honoring of a creditor's draft under a letter of credit created or perfected its security interest as against the debtor, the automatic stay would enjoin it. Honoring the letter, however, does neither. The security interest of the bank "attaches" under Article 9 when the security agreement is executed, when the debtor has rights in the collateral, and when the secured party gives "value."⁵⁷ The security interest is "perfected" when, in addition to these steps, a financing statement has been filed.⁵⁸ The execution of the security agreement, the filing of the financing statement, and the debtor's obtaining rights in the collateral are events in the bank's control that take place before the petition is filed. One might argue that perfection occurs only when the seller's drafts are paid, because only then does the bank give value. But the definition of "value" under the relevant section of the Uniform Commercial Code is broad.⁵⁹ The bank's binding obligation to honor the letter of credit is itself the giving of value.⁶⁰ Thus, the security interest is perfected before the petition is filed and before the automatic stay provision takes effect.

One could argue, however, that the state law governing the attachment does not determine the moment of "creation" of a security interest under section 362 and that the security interest is not created for bankruptcy purposes until the bank's liability is no longer contingent. In that case, the automatic stay could still prevent payment under the letter of credit. Such an interpretation of

⁵⁶ 11 U.S.C. § 362(a) (Supp. III 1979) provides that "[e]xcept as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title operates as a stay, applicable to all entities, of . . . (4) any act to create, perfect, or enforce any lien against property of the estate."

⁵⁷ U.C.C. § 9-203(1)-(2).

⁵⁸ *Id.* § 9-302. Filing is sometimes unnecessary for perfection. See, e.g., *id.* §§ 9-302 to -306.

⁵⁹ *Id.* § 1-201(44) provides:

Except as otherwise provided . . . a person gives "value" for rights if he acquires them (a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; or

(b) as security for or in total or partial satisfaction of a pre-existing claim; or

(c) by accepting delivery pursuant to a pre-existing contract for purchase; or

(d) generally, in return for any consideration sufficient to support a simple contract.

⁶⁰ See *Prisbrey v. Noble*, 505 F.2d 170, 176 (10th Cir. 1974).

section 362 is countertextual, however, because it puts the date of creation after the date of perfection. More importantly, interpreting the honoring of a letter of credit as creating a security interest furthers no principles of bankruptcy law. As long as the stay prevents any enforcement of the bank's security interest (as it clearly does), the debtor's interests are not compromised if the letter is honored. Because the purpose of the automatic stay is to protect the debtor from undue pressure in the wake of bankruptcy,⁶¹ "creation" under section 362(a)(4) is most persuasively limited to situations in which new security interests, including those created by old creditors, are entered into after the petition is filed.

Section 549 of the Bankruptcy Code, which authorizes the trustee to "avoid a transfer of property of the estate . . . that occurs after the commencement of the case,"⁶² might be interpreted as giving the trustee power to enjoin the bank from honoring the letter of credit. This argument assumes that the transfer of the security interest from the debtor to the bank occurs when the bank actually pays the draft under the letter, not when it bound itself to pay it. But even if the state law governing the attachment and perfection of security interests does not determine the moment of transfer under federal bankruptcy law, it is more sensible to read section 549 as giving the trustee the power to render the security interest unenforceable rather than the power to enjoin the honoring of the letter of credit. It should be a matter of indifference to the trustee whether the bank suffers from an unenforceable security interest or the beneficiary suffers from an unenforceable letter of credit.

The court in *Twist Cap* erred in asserting that the bank's honoring of the letter of credit "would certainly be counterproductive to the debtor's efforts to obtain rehabilitation."⁶³ The mere transfer of money from one claimant against the debtor's estate to another cannot affect the debtor's rehabilitation. An injunction would only disrupt the fundamental and long-established principle governing letters of credit—that the bank's obligation to pay is independent of the underlying transaction.

⁶¹ See S. REP. NO. 989, 95th Cong., 2d Sess. 54-55 (1978), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5840-41.

⁶² 11 U.S.C. § 549 (Supp. III 1979); see note 77 *infra*.

⁶³ *Twist Cap, Inc. v. Southeast Bank*, 1 Bankr. 284, 285 (Bankr. D. Fla. 1979).

IV. THE TRUSTEE'S POWER TO AVOID THE BANK'S SECURITY INTEREST

The most difficult question raised by *Twist Cap* is whether the trustee in bankruptcy can prevent the bank from enforcing its security interest once the letter of credit is honored. The question is difficult not only in terms of statutory construction, but also in terms of its possibly broad effect. More than the right of the bank that issues standby letters of credit is at stake. If a security interest supporting the bank's contingent obligation to pay the seller cannot survive in bankruptcy, neither should a security interest asserted by a guarantor or other party contingently liable for the debts of the buyer. Because guarantors figure in many commercial transactions,⁶⁴ and because they frequently retain security interests, it is unlikely that Congress meant to deny them the rights of secured creditors on the ground that their obligations were contingent. That obligations are contingent does not mean they are insubstantial. The Bankruptcy Code expressly acknowledges this by recognizing contingent claims and rights of subrogation.⁶⁵

Two sections of the Bankruptcy Code arguably give the trustee in bankruptcy the power to prevent the bank that has honored its letter of credit from enforcing its security interest. Section 547⁶⁶ allows the trustee to avoid preferential transfers within ninety days before the filing of the bankruptcy petition. Section 549⁶⁷ allows the trustee to avoid postpetition transfers of the debtor's property. I examine these sections in turn.

A. Voidable Preferences

Whether the trustee can set aside the bank's security interest for a letter honored before the petition was filed is a straightforward question under section 547, which allows the trustee to avoid certain transfers "of property of the debtor . . . for or on account of an antecedent debt . . . made . . . on or within 90 days before the filing of the petition."⁶⁸ There cannot be such a voidable pref-

⁶⁴ A common example is the case where a parent corporation guarantees loans made to its subsidiary.

⁶⁵ See 11 U.S.C. §§ 101(4), 509(a) (Supp. III 1979).

⁶⁶ *Id.* § 547; see note 68 *infra*.

⁶⁷ 11 U.S.C. § 549 (Supp. III 1979); see note 77 *infra*.

⁶⁸ 11 U.S.C. § 547(b) (Supp. III 1979) provides in full:

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—

erence unless the "debt" is incurred before the "transfer." If this section is to authorize the trustee to void the bank's security interest, there must have been a preexisting debt to the bank and a transfer of the security interest within the ninety-day preference period.

Under the new Bankruptcy Code, a debt "means liability on a claim,"⁶⁹ and "claim" encompasses a "right to payment, whether or not such right is . . . contingent."⁷⁰ When the bank agrees to issue a letter of credit, it exacts an enforceable right to payment that is contingent on the letter being drawn upon. A debt therefore exists when the bank and its customer enter into their security agreement and the bank issues the letter, even if none of the other steps necessary for attachment or perfection have taken place.

Thus, if the bank has filed a financing statement before the preference period, the threshold question remains whether transfer takes place when there is attachment and perfection under state law or when the bank's liability ceases to be contingent.⁷¹ The

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- (1) to or for the benefit of a creditor;
 - (2) for or on account of an antecedent debt owed 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.

If the bank's security interest is transferred only when it honors the letter of credit, requirements (1), (3), and (5) probably are satisfied. Because the bank is a creditor, requirement (1) clearly is met. Requirement (3) probably is met because the debtor is presumed insolvent during the 90-day preference period. *Id.* § 547(f). Because the bank would be an unsecured creditor in the absence of the transfer of the security interest, the transfer probably would improve its position so as to satisfy requirement (5).

⁶⁹ *Id.* § 101(11).

⁷⁰ *Id.* § 101(4)(A); see note 40 *supra*.

⁷¹ The First Circuit has held that the date of transfer of a security interest relates back to the date of the agreement. *Torrech Nieves v. Maryland Cas. Co.*, 373 F.2d 510, 511 (1st Cir. 1967) (decided under the old bankruptcy law) (not explicitly addressing the voidable transfer problem). The First Circuit recognized, however, that the authority was split. *Id.*; cf. *Gray v. Travelers Indem. Co.*, 280 F.2d 549, 554 (9th Cir. 1960) (holding that conditional assignment of contract right relates back to the time of agreement, but noting the split of

security interest is voidable only in the latter case. Federal bankruptcy law is built on a foundation of state law property rights. Unless federal bankruptcy interests require some alteration of these rights, they persist when asserted in a bankruptcy proceeding.⁷²

Under section 547(e), a transfer is made "at such time such transfer takes effect between the transferor and the transferee" if the transfer is perfected within ten days and if the debtor already has rights in the property transferred.⁷³ Under state law, the transfer takes effect when the parties enter into the security agreement and the bank issues the letter, which is well before the debtor becomes insolvent.⁷⁴ No special policies of section 547 commend finding the moment "transfer takes effect" to occur at any other time than as state law provides.

Section 547 protects general creditors from being unfairly disadvantaged by last-minute transfers by the debtor on the eve of its

authority).

⁷² See *Butner v. United States*, 440 U.S. 48, 54-55 (1979):

The Bankruptcy Act does include provisions invalidating certain security interests as fraudulent, or as improper preferences over general creditors. Apart from these provisions, however, Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.

Of course, Congress has the power to define the moment of transfer as it pleases. See Countryman, *The Use of State Law in Bankruptcy Cases* (pt. 2), 47 N.Y.U. L. Rev. 631, 632 (1972). Congress has done this in the context of security interests in after-acquired property. 11 U.S.C. § 547(e)(3) (Supp. III 1979). In the absence of any exercise of such power, however, state law definitions of when property rights arise should control. See 2 G. GILMORE, *supra* note 23, § 45.2, at 1284.

⁷³ 11 U.S.C. § 547(e) provides in part:

(2) For purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made—

(A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time;

(B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or

(C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—

(i) the commencement of the case; and

(ii) 10 days after such transfer takes effect between the transferor and the transferee.

(3) For the purpose of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

⁷⁴ See text and notes at notes 56-60 *supra*.

demise.⁷⁵ In letter-of-credit transactions, however, neither the debtor nor the bank controls the timing of the bank's claim to the debtor's property, because the claim arises when the beneficiary forces the bank to pay under the letter. The default of the debtor does trigger the beneficiary's right to payment, but such a default hardly can be called a "preference" in favor of the bank. The bank is better off if the default never takes place and the letter is never called upon.

One might argue that the default is a preference in favor of the letter's beneficiary. The debtor's deliberate default might seem no less a preference than a decision by a debtor to pay a general creditor in cash. Either action brings about full satisfaction of the claim and depletes the debtor's estate by a corresponding amount. But there is a crucial difference: under a letter of credit, the beneficiary is ultimately paid regardless of the actions of the debtor. If the debtor defaults, the beneficiary is paid through the letter of credit. If not, the beneficiary is paid in the ordinary course of the underlying commercial transaction. The debtor can choose *how* the creditor is paid, but it cannot determine *whether* it is paid. Thus, no act of the debtor during the ninety-day period "prefers" the beneficiary. Like a secured creditor, it is "preferred" only because of a binding agreement publicly noted in a financing statement prior to the ninety-day period. Such "preferences" do not offend the policy of section 547 of preventing last-minute manipulations by the debtor for the benefit of some creditors at the expense of others.⁷⁶

⁷⁵ See H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78 (1977), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6138. In addition to ensuring that creditors share equally in the debtor's estate, section 547 ensures that the debtor is not "dismembered" in a last-minute rush to obtain liens on the debtor's property. *Id.* The security interest arising from the letter of credit does not result from any last-minute race to the courthouse, of course, but from a bargain that preceded that debtor's insolvency.

⁷⁶ The debtor's inability to manipulate its affairs to benefit one of its creditors distinguishes the bank's security interest from security interests in after-acquired property. In enacting section 547, Congress passed special rules to handle cases like *Grain Merchants v. Union Bank & Sav. Co.*, 408 F.2d 209, 214-15 (7th Cir.), *cert. denied*, 396 U.S. 827 (1969), which protected a creditor's security interest in property acquired in the 90-day preference period when all other steps for protecting the security interest had taken place outside the period, because these "floating liens" are subject to debtor manipulation. The debtor that wants to favor the holder of the floating lien can deliberately build up the asset to which the lien attaches. Instead of paying off trade creditors, for example, it could build up its inventory. Such last-minute favoritism is not possible in the letter-of-credit transaction, because the letter's beneficiary structured the transaction so that it is paid, regardless of the debtor's actions.

B. Postpetition Transfers

Whether the bank can enforce its security interest if it honors the beneficiary's draft under the letter of credit after the filing of the bankruptcy petition also turns on the moment of transfer, although section 549⁷⁷ rather than section 547 controls. We might turn for guidance on this question to section 502(e)(2),⁷⁸ which mandates that a claim for reimbursement that becomes fixed after the filing of the petition be treated as if the claim had become fixed before the filing.⁷⁹ Section 502, however, says nothing about when a transfer of property securing a contingent liability occurs; it says only that the "claim" (whether secured or not) must be treated as if it arose before the petition. Moreover, section 502 is expressly subject to the voidable-preference powers of the trustee under sections 547 and 549.⁸⁰

I have argued that none of the principles underlying section 547 commend finding a transfer at the moment the bank's contingent liability becomes certain;⁸¹ the same is true of section 549. Section 549 prevents creditors from gaining unilateral advantages at the expense of other creditors after the filing of the petition, just as section 547 prevents such misbehavior before the filing. In a letter-of-credit transaction, however, the obligation for which the bank claims a security interest arose long before the petition. The

⁷⁷ 11 U.S.C. § 549(a) (Supp. III 1979) provides:

Except as provided in subsection (b) and (c) of this section, the trustee may avoid a transfer of property of the estate—

(1) that occurs after the commencement of the case; and
 (2)(A) that is authorized under section 303(f) or 542(c) of this title; or
 (B) that is not authorized under this title or by the court.

Subsections (b) and (c) are inapplicable: subsection (b) explicitly does not apply to transfers that secure a debt, and subsection (c) concerns judicial sales of real property.

⁷⁸ 11 U.S.C. § 502(e)(2) (Supp. III 1979) provides:

A claim for reimbursement or contribution . . . that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

⁷⁹ In the House debate on the new Bankruptcy Code, Representative Edwards appears to have contemplated a surety with a security interest in the debtor's property when he discussed the effect of section 502(e)(2). See 124 CONG. REC. H11,094 (daily ed. Sept. 28, 1978). The remarks are not completely clear, however. See 3 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 502.05, at 502-80 n.15 ("[T]he comment suggests a difference between the advantage to the surety where the claim is secured or unsecured, depending upon the facts. The comments themselves, however, use the word 'secured' in both instances, an obvious error in some fashion.").

⁸⁰ 11 U.S.C. § 502(a) (Supp. III 1979).

⁸¹ See text and notes at notes 71-76 *supra*.

bank's claim on property in the debtor's estate arose while the debtor was solvent, and it was noted properly in a public filing. We do not confront a deal made by the bank, beneficiary, and debtor after the petition was filed.

Arguably, section 549 also ensures that the debtor's status is frozen at the moment of bankruptcy. Except as the provisions of the Code governing the administration of the estate permit, parties are not allowed to alter the size of the debtor's estate. Under this view, if the bank has no vested interest in the debtor's property before the petition is filed, it should not have one afterwards, except as the Bankruptcy Code specifically allows.⁸² Finding a "transfer" in an act beyond the bank's control would be appropriate, according to this interpretation, because it preserves the status quo.

The Bankruptcy Code as a whole, however, does not reveal a policy to exclude contingent liabilities to keep the debtor's estate stable. Though section 502 does not address the question of when a transfer occurs, it does recognize explicitly the need to accommodate contingent liabilities.⁸³ Nothing in the Code suggests that a debt should be relegated to an inferior status merely because it is contingent.

Moreover, the consequences of honoring a letter of credit should be the same under sections 547 and 549 lest awkward problems of consistency arise. The beneficiary of the letter may choose when to present its draft to the bank, and might do so after the bankruptcy petition is filed even if it acquired the right to present it earlier. If honoring the letter before the petition did not give rise to a voidable transfer but honoring it after the petition did, the beneficiary could control the bank's chances of ultimate repayment.

CONCLUSION

This article has examined the questions raised by the *Twist*

⁸² 11 U.S.C. § 549(a)(2)(B) (Supp. III 1979) supports this view by defining the scope of the trustee's avoidance power negatively, excluding from that power transfers specifically authorized by the Bankruptcy Code.

⁸³ *Id.* § 502(c) provides:

There shall be estimated for purpose of allowance under this section—

- (1) any contingent or unliquidated claim, fixing or liquidation of which, as the case may be, would unduly delay the closing of the case; or
- (2) any right to an equitable remedy for breach of performance if such breach gives rise to a right to payment.

Cap case. I have argued that *Twist Cap* is wrongly decided and that it unnecessarily throws into doubt the validity of a useful commercial financing device. A bankruptcy court should never enjoin a bank from honoring a letter of credit on the ground that honoring the letter would lead the bank to assert a security interest in the debtor's property.⁸⁴ The bank's obligation to the beneficiary under the letter of credit is independent of the transaction between the bank and its now insolvent customer and affects neither the debtor's estate nor other creditors. Whether the bank can enforce its security interest after it honors the letter of credit is a more difficult question. On balance, however, the most natural and sensible interpretation of the relevant sections of the Bankruptcy Code is that, when a contingent liability is at issue, a security interest is "transferred" when the security interest attaches and is perfected under state law.⁸⁵ When attachment and perfection under state law take place more than ninety days before bankruptcy, the bank's security interest should survive the trustee's attack.

⁸⁴ It can assert, however, the debtor's right to enjoin payment if there are forged or fraudulent documents accompanying the seller's draft or if there is fraud in the transaction. See note 53 *supra*.

⁸⁵ State law controls, except, of course, for security interests in after-acquired property. See 11 U.S.C. § 547 (Supp. III 1979); note 76 *supra*.