

EFFECT OF BANKRUPTCY ON RENEWAL OF LETTER OF CREDIT

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Introduction

Is the beneficiary of a letter of credit, issued as a prejudgment remedy in an action commenced prior to the debtor's bankruptcy filing, entitled to receive "adequate protection" in the form of an order by the bankruptcy court compelling the debtor to renew or replace the letter of credit? The Second Circuit Court of Appeals, in *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc.*, 2003 U.S. App. LEXIS 24192 (2nd Cir. Dec. 3, 2003), answered this question in the negative.

Background

Pursuant to an enforcement action for breach of a dairy-products-requirements contract action brought by New England Dairies, Inc. ("NED") against Dairy Mart Convenience Stores, Inc. and Dairy Mart, Inc. (collectively, "Dairy Mart"), the Federal district court in Connecticut ordered, as a prejudgment remedy under an applicable Connecticut statute, that Dairy Mart post either a bond, a letter of credit, or other security approved by the court in the amount of \$2,750,000. Dairy Mart elected to furnish a letter of credit in this amount, with NED as the beneficiary. Because of its (justifiable) concern that the one-year letter of credit would expire before the pending litigation was concluded, or might be unenforceable if a bankruptcy proceeding was filed by or against Dairy Mart, NED sought an order from the court directing Dairy Mart to procure a replacement letter of credit that it could draw upon if there was a failure to renew or if Dairy Mart filed for bankruptcy. But the district court instead ordered only that Dairy Mart renew or replace the letter of credit at least sixty days before its current expiration date as necessary until the litigation was concluded. The letter of credit, by its terms, provided that it could not be drawn upon until sixty days after final judgment in favor of NED or, if Dairy Mart appealed, sixty days after the judgment was affirmed.

After two renewals of the Letter of Credit (the last on December 13, 2000 with an expiry date of February 5, 2002), Dairy Mart filed its Chapter 11 bankruptcy petition on September 24, 2001, and declined any further renewal. NED immediately sought to lift the automatic stay to enable the district court to proceed with the pending litigation and issue a judgment in the contract action. The bankruptcy court granted the motion and, a few days later, also "authorized Dairy Mart to pay certain pre-petition secured debts, an order that would have rendered NED's letter of credit enforceable in accordance with its terms under the debtor-in-possession financing agreement." *Id.* at *4. But since the letter of credit by its terms could not actually be drawn until after a final judgment had been entered by the district court in the contract action, and in the interim the letter of credit

would expire unless renewed before the current expiration date, NED asked the bankruptcy court to order Dairy Mart to comply with the prejudgment remedy authorized by the district court in the contract action and compel Dairy Mart to renew the letter of credit, as “adequate protection” for NED’s interest under sections 361 and 362 of the Bankruptcy Code (“Code”).

In the alternative, NED asked the bankruptcy court to lift the automatic bankruptcy stay under section 362(a) of the Code to allow the district court judge in the contract action enforce his own order with respect to renewal of the letter of credit, or to provide equitable relief to NED under section 105(a) of the Code (which gives the bankruptcy court equitable power to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title”). The bankruptcy court denied this requested relief, assuming (but not deciding) that NED was a secured creditor for purposes of seeking adequate protection under section 361 of the Code. The bankruptcy court held that the obligation to provide a replacement letter of credit was not itself collateral but was instead a dischargeable obligation, because granting the requested relief would result in a post-petition preference for NED’s claim. The bankruptcy court further ruled that section 105(a) of the Code was inapplicable because it does not provide relief on its own and NED’s motion had not specifically invoked any other provision of the Code. The bankruptcy court also reasoned that the equities did not favor NED because it could have sought additional relief from the district court but had failed to do so.

NED then filed an emergency appeal with the U.S. District Court for the Southern District of New York, which affirmed the bankruptcy court’s ruling on January 25, 2002. On February 5, 2002, the Connecticut district court issued its ruling in the contract action, finding that Dairy Mart had breached the contract and awarding NED damages in the amount of \$960,000 for lost profits. The letter of credit expired the next day, sixty days before NED was entitled to draw on it.

The Second Circuit’s Decision

The Second Circuit dealt first with NED’s argument that it was entitled to adequate protection under section 361 of the Code. The court noted that section 361 protects only secured creditors and provides that a party is entitled to adequate protection of its security interest when the automatic stay endangers “an interest of an entity in property” of the estate. The court further noted that NED sought adequate protection for its interest in the \$2.75 million letter of credit by asking the bankruptcy court to compel Dairy Farm to renew the letter of credit but that the bankruptcy court, while assuming that NED was a secured creditor, denied the request because it ruled that “the obligation to provide replacement collateral is, in effect, an obligation to secure a pre-petition claim which is stayed by Section 362.” *Id.* at *8 (quoting from bankruptcy court opinion).

The Second Circuit agreed with the bankruptcy court that NED was not entitled to adequate protection but, contrary to the bankruptcy court’s conclusion, ruled that “NED

is ineligible to receive adequate protection because it is not a secured creditor as defined by the Bankruptcy Code.” *Id.* The Second Circuit referred to section 506(a) of the Code, which defines “secured claim” as “an allowed claim of a creditor secured by a *lien on the property in which the estate has an interest.*” *Id.* at *9 (emphasis in text). The court ruled that NED’s only interest was in the letter of credit and that it had no direct interest in any of the property of Dairy Mart. The court reasoned that the fact that the bank that issued the letter of credit may have obtained collateral from Dairy Mart, and thus may have had a claim back against Dairy Mart if it had to pay on the letter of credit, had no bearing on the rights of NED because of the “independence principle” with respect to letters of credit. The independence principle (supported by numerous bankruptcy decisions) provides that a letter of credit is an independent third-party obligation and the proceeds thereof are not the debtor’s property even if the letter of credit is secured by the debtor’s property. According to the Second Circuit, “[t]he letter of credit creates a conditional claim on the assets of the bank; it does not create a security interest in the assets of NED.” *Id.* at *11. According to the court, NED therefore was itself only an unsecured creditor and ineligible to receive adequate protection. The court scolded NED for not insisting, in the federal district-court contract action, that Dairy Mart provide security in the form of a direct interest in property of Dairy Mart.

The Second Circuit also rejected NED’s argument that it was entitled to relief from the automatic stay to allow the district court in the contract action to enforce its order regarding the required renewals of the letter of credit, noting that such relief was solely in the discretion of the bankruptcy court and that under section 362(d)(1) of the Code the stay could only be lifted “for cause, including the lack of adequate protection of an interest in the property.” The Second Circuit ruled that because it had already determined that NED had no interest in any of Dairy Mart’s property, it followed that NED had no right to adequate protection or relief from the stay.

Finally, the Second Circuit rejected NED’s assertion that it was entitled to relief under section 105(a) of the Code, finding that the equitable relief available under this section could be provided only “within the confines of the Bankruptcy Code,” and not just to “do the right thing.” *Id.* at *13-14. The Second Circuit ruled that even though NED’s motion might “implicate” sections 361 and 362 of the Code, it had already determined that NED was not entitled to relief under these sections, which therefore were inapplicable and unavailable with respect to the claimed equitable relief. Furthermore, the court reasoned that in any event the equities of the case favored Dairy Mart and not NED, because NED failed to act in its own interest in the federal district-court contract action and anticipate the circumstances that transpired, i.e., NED relied to its detriment on the letter of credit and the federal district court’s renewal order, “despite its knowledge that Dairy Mart could file a bankruptcy petition that would impede the collection of unsecured debts.” *Id.* at *14. According to the court, “[e]quity does not permit NED to move to the head of the creditors’ line after if failed to properly secure its own interest.” *Id.* at *15.

Discussion

1. Both the bankruptcy court and the Second Circuit chastised NED for taking a renewable letter of credit as security instead of one of the alternative forms of security offered pursuant to the order of the district court in the breach-of contract action – which, unlike the letter of credit, would have been direct obligations of the debtor and not subject to bankruptcy risk. However, NED clearly realized the bankruptcy risk involved with accepting a renewable letter of credit from the debtor, renewable annually, in the federal district-court contract action. To counter this risk, NED sought a ruling from the district court that would permit it to draw on the letter of credit immediately upon Dairy Mart’s failure to renew it, or upon a bankruptcy filing by or against Dairy Mart. When the district court refused to grant this request (requiring instead that Dairy Mart renew or replace the letter of credit sixty days before its expiration during the course of the litigation), perhaps NED should have requested, as a replacement, one of the alternative forms of security available pursuant to the district court’s order -- i.e., “other security . . . approved by the court,” in the form of property owned directly by the debtor. NED may also have considered requesting the court to order Dairy Mart to provide an “evergreen” letter of credit, i.e., one that required the issuing bank to automatically renew the letter of credit for successive one-year periods unless the issuer notified NED otherwise in writing at least 30 days prior to the then-current expiration date (in which event NED would immediately be entitled to draw on the letter of credit).
2. After a court hearing on the merits of the district court breach-of-contract case, NED filed a “prejudgment remedy application.” A Connecticut statute, Conn. Gen. Stat. sec. 52-278a *et seq.*, permits a plaintiff, after a court hearing on the merits of the case but before judgment, to attach and preserve the assets of the defendant while the matter is being litigated, if the court determines that there is probable cause to sustain the validity of the plaintiff’s claim. The Second Circuit concluded, after hearing testimony and examining NED’s and Dairy Mart’s pleadings and proofs, that such probable cause existed and granted NED’s application for the statutory prejudgment remedy, but did not agree to provide the renewal and bankruptcy protection specifically sought by NED.
3. The court’s message is clear: when a creditor elects to take a renewable letter of credit (or other indirect security provided by a third party) as security for the debtor’s obligation, it will not be deemed to be a secured creditor under the Code in the debtor’s subsequent bankruptcy proceeding, solely as the result of its interest in the letter of credit, and will not be entitled to adequate protection under sections 361 or 362 of the Code, which apply only to secured creditors of the debtor. Although Connecticut’s pre-judgment-remedy statute is unusual, the court’s ruling in the *Dairy Mart* case should serve as a cautionary tale for a creditor taking a standby letter of credit in connection with a real estate transaction (such as a lease security deposit or additional collateral in connection

with a mortgage loan), where the creditor anticipates that it will be necessary to renew or replace the letter of credit periodically until the debtor's obligation to the creditor is extinguished. Although the independence principle generally protects creditors in real estate transactions (because it enables the creditor to receive the letter-of-credit proceeds notwithstanding the debtor's bankruptcy), it will prevent the creditor from being deemed to have an interest in the debtor's subsequent bankruptcy proceeding solely as a result of the letter of credit, and prevent any attempt to force the debtor to renew the letter of credit regardless of the debtor's agreement to do so. This should not be a problem if, as is usually the case, the letter of credit states that it is irrevocable and unconditional and immediately payable upon presentation of a sight draft by the creditor, and is not subject to any further conditions such as the resolution of litigation between the parties resulting in a judgment in favor of the creditor. As noted in paragraph 1 above, as a further precautionary measure the letter of credit should also contain, where possible, an evergreen provision that provides for automatic successive one-year renewals of the letter of credit by the issuing bank and grants the creditor the immediate right to draw on the letter of credit if it is not timely renewed or replaced. The following is a sample evergreen provision in a letter of credit that secures a tenant's security-deposit obligation:

THIS LETTER OF CREDIT IS ISSUED, PRESENTABLE AND PAYABLE AT OUR OFFICE AT _____ AND EXPIRES WITH OUR CLOSE OF BUSINESS ON _____. IT IS A CONDITION OF THIS LETTER OF CREDIT THAT IT SHALL BE AUTOMATICALLY EXTENDED FOR ADDITIONAL TWELVE-MONTH PERIODS THROUGH _____ **[INSERT A DATE WHICH IS AT LEAST THIRTY (30) DAYS AFTER THE EXPIRATION OF THE TERM OF THE LEASE]**, AND WE HEREBY AGREE TO GIVE YOU WRITTEN NOTICE OF SUCH EXTENSIONS IN WRITING BY THE ___ DAY OF _____ **[INSERT THE DAY AND THE MONTH THIS LETTER OF CREDIT IS ISSUED]** OF EACH YEAR DURING THE TERM HEREOF. IF FOR ANY REASON WE DETERMINE THAT THIS LETTER OF CREDIT SHALL NOT BE EXTENDED, WE HEREBY AGREE TO SEND YOU WRITTEN NOTICE THEREOF IN WRITING BY CERTIFIED MAIL, RETURN RECEIPT REQUESTED, AT LEAST THIRTY (30) DAYS PRIOR TO THE EXPIRATION DATE. IN THE EVENT THIS CREDIT IS NOT EXTENDED FOR AN ADDITIONAL PERIOD AS PROVIDED ABOVE, YOU MAY DRAW HEREUNDER. SUCH DRAWING IS TO BE MADE BY MEANS OF A DRAFT ON US AT SIGHT, WHICH MUST BE PRESENTED TO US BEFORE THE THEN EXPIRATION DATE OF THIS LETTER OF CREDIT. THIS LETTER OF CREDIT CANNOT BE MODIFIED OR REVOKED WITHOUT YOUR CONSENT. THIS LETTER OF CREDIT IS PAYABLE IN MULTIPLE DRAFTS AND SHALL BE TRANSFERABLE UPON OUR RECEIPT OF YOUR INSTRUCTIONS

AND THE ORIGINAL OF THIS LETTER OF CREDIT AND AMENDMENTS, IF ANY, WITHOUT ADDITIONAL CHARGE.

4. For related decisions in this area, *See In re Farm Fresh Supermarkets of Maryland, Inc.*, 257 B.R. 770, 772-73 (Bankr. D. Md. 2001) (rejecting bankruptcy trustee's argument that proceeds of letter of credit posted for benefit of landlord creditor should be returned to bankruptcy estate where creditor drew on letter of credit post-petition; and finding that "a standby letter of credit . . . is a distinct type of financing document that is more akin to a guarantee than to the usual letter of credit;" the court stated further that "neither the letter or its proceeds were property of the debtor's estate, and therefore the trustee may not maintain the instant lawsuit to recover them"); *In re Keene Corp.*, 162 B.R. 935, 942 (Bankr. S.D.N.Y. 1994) ("The letter of credit is an independent third party obligation, and the proceeds are not the debtor's property even if . . . [i]t is secured by the debtor's property"); *Willis v. Celotex Corp.*, 978 F.2d 146 (4th Cir. 1991) (holding that automatic stay did not apply to irrevocable letter of credit issued by bank to debtor's surety, and because letter of credit was not property of estate surety could draw on it if debtor defaulted on supersedeas bond posted by surety on debtor's behalf without violating automatic stay); *In re Del. River Stevedores, Inc.*, 129 B.R. 38, 40 (Bankr. E.D. Pa. 1991) (noting court took comfort in creditor's allegation that debtor's bankruptcy was not sole reason for its draw under letter of credit); *American Nat'l Bank and Trust Co. of Chicago v. Hamilton Ind. International, Inc.*, 583 F.Supp. 164, 169 (N.D. Ill. 1984) ("[t]he distinction between a standby letter of credit and a true guarantee is that the former is a direct obligation to pay upon 'specified documents showing a default' while the latter is a secondary obligation requiring 'proof of the fact of default'" (citations omitted)); *Consolidated Aluminum Corp. v. Bank of Virginia*, 544 F.Supp. 386, 394, *aff'd* 704 F.2d 136 (4th Cir. 1983) ("[t]he standby letter of credit functions somewhat in the manner of a guaranty or a surety bond, and thus is utilized to guarantee the performance of a wide variety of obligations"); *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989) (rejecting debtor's request to preliminarily and permanently enjoin creditor from pursuing state-court action against guarantor of debtor's plan); *In re Zale Corp.*, 62 F.3d 746, 760 (5th Cir. 1996) (following *American Hardwoods, supra*, and stating that it "must overturn a § 105 injunction if it effectively discharges a nondebtor"); *Shandri Holdings, Corp. v. Kmart Corp. (In re Kmart Corp.)*, 297 B.R. 525, 529 (N.D. Ill. 2003) ("letters of credit are not considered property of the bankruptcy estate"); *Kellog v. Blue Quail Energy, Inc. (In re Compton, Inc.)*, 831 F.2d 586, 589 (5th Cir. 1997) ("when the issuer [of a letter of credit] honors a proper draft under a letter of credit, it does so from its own assets and not from the assets of [the debtor] who caused the letter of credit to be issued"); *Duplitronics, Inc. v. Concept Design and Mfg. Inc. (In re Duplitronics)*, 183 B.R. 1010, 1015 (Bankr. N.D. Ill. 1995) ("It is axiomatic that letters of credit represent obligations of the bank completely independent of the underlying transaction . . . 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"); *United States Trust Co. of New York v. Revere Copper & Brass, Inc. (In re Revere Copper & Brass)*, 60 B.R. 887, 891 (Bankr. S.D.N.Y. 1985) (once bank makes payment on letter of credit, it [and not beneficiary] acquires right to be indemnified by debtor, and converts its claim against debtor to an absolute claim); *In re Wedtech Corp.*, 187 B.R. 105, 107 (Bankr. S.D.N.Y. 1995) ("When a debt is secured by collateral pledged by a third party, the security interest does not give rise to a secured claim against the debtor's estate"). See also Christopher Leon, *Letters of Credit: A Primer*, 45 Md. L.Rev. 432, 442-43; Kimberly S. Winick, *Tenant Letters of Credit, Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 740 (2001) ("Of course, if the landlord can rely on the tenant's nonperformance of other obligations under the lease, it should do so. Even though the tenant is not a party to the letter of credit, the tenant may try to argue that terms of the letter of credit that permit a draw merely because the tenant is in bankruptcy are unenforceable ipso facto clauses. Such other obligations include, but obviously are not limited to, timely payment of rent, timely payment of common area charges, repair and maintenance of the property in conformance with agreed standards, payment of taxes, and maintenance of adequate insurance with the landlord (and its mortgage lender) named as additional insureds. Additionally, the landlord should be able to draw under the letter of credit without the tenant's cooperation. For example, the draw should not be conditioned on the presentation of documents that must be executed by the tenant, as the landlord cannot compel execution by a tenant in bankruptcy. Similarly, draws should not be conditioned on the landlord's prior notice of default, notice of acceleration, or demand on the tenant for payment; upon commencement of the tenant's bankruptcy case, default notices, notices of acceleration, and demands for payment for amounts due pre-bankruptcy are stayed by section 362(a).").