THE COMMERCIAL SURETY'S COLLATERAL IN A PRINCIPAL'S BANKRUPTCY CASE

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I. Introduction.

There is an enormous market in the United States for commercial surety bonds of all types and to cover a wide variety of obligations.[1] For the purposes of this paper, commercial surety bonds will include: judicial bonds, fiduciary/probate bonds, license and permit bonds, various statutory bonds, release and discharge bonds, commercial surety performance bonds (subdivision bonds, reclamation bonds and others), non-statutory guaranty and/or faithful performance bonds, public official bonds, and others.[2] Because of the nature of the commercial surety bond obligations, the surety may require, either at the inception of the suretyship relationship and the execution of the commercial surety bonds, or later when the surety demands to be "placed in funds," that the surety receive collateral in some form from the principal in order to secure the surety for its obligations under the commercial surety bonds. The surety's intent generally is to use the collateral to exonerate and/or reimburse itself in the event the surety faces a loss under the commercial surety bonds. However, the surety's ability to use the collateral, and even maintain its rights in the collateral, may change when the principal files a bankruptcy case.[3]

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1 For the purposes of this paper, the commercial bond surety is referred to as the "surety;" the surety's principal is referred to as "principal" at all times, whether before the principal files its bankruptcy case or after the principal files its bankruptcy case and becomes a debtor; and commercial surety bonds of all types and for many obligations are referred to as "commercial surety bonds" unless a specific type of commercial surety bond is described.

2 For a brief listing of many different kinds of commercial surety bonds, *see* THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE, 2D ED. 448-58 (Marilyn Klinger, George J. Bachrach and Tracy L. Haley, eds. 2008), hereinafter referred to as the "SURETY INDEMNITY AGREEMENT."

3 For the purposes of this paper, it is assumed that the principal's bankruptcy case is a chapter 11 reorganization under the United States Bankruptcy Code (the "Bankruptcy Code"). While many of the discussions in this paper would be applicable to a principal becoming a debtor pursuant to a chapter 7 liquidation under the Bankruptcy Code, the situations in which a surety may have collateral from the principal prior to the principal's bankruptcy case would indicate that the principal's bankruptcy case is filed under chapter 11 of the Bankruptcy Code.

This paper will explore a number of issues concerning the surety's ability to maintain and use the collateral it obtains from its principal in order to secure the surety for its obligations under the commercial surety bonds in the event its principal files for bankruptcy. Initially, the paper will review the different types of collateral that a surety may obtain and the bankruptcy effect on those different types of collateral. The paper will then address three issues: (a) the surety's right and ability to use the surety's collateral after the principal files for bankruptcy; (b) claims by the obligee and other potential third party claimants against the commercial surety bonds that may result in the surety's need to use the collateral to avoid loss; and (c) maintaining and preserving the surety's collateral for future claims (namely, what eventually may happen to the surety's collateral in the principal's bankruptcy case). [4]

II. Underwriting the Principal and Obtaining the Collateral.

There is an ancient proverb that a bird in the hand is worth two in the bush.[5] Thus, while the surety may have a strongly worded indemnity agreement requiring reimbursement and the principal may have solemnly promised to reimburse the surety for any and all losses in exchange for issuance of bonds; ancient wisdom dictates that it is better to have collateral in hand than a promise to pay later. Sureties have learned this ancient teaching the hard way over the many years. Accordingly, commercial sureties will generally look for some form of collateral as part of the underwriting process for the issuance of commercial surety bonds. Sureties generally address collateral in one of three ways – requiring the principal to provide the surety with collateral up front as a condition of issuing the commercial surety bonds; requiring the principal to provide collateral to the surety after the issuance of commercial surety bonds in order for the surety to forebear from cancelling bonds and/or to issue new bonds because of the financial condition of the principal and requiring the principal to provide collateral pursuant to a "collateral demand" or request to be "placed in funds" after the issuance of the commercial surety bonds again because of the principal's financial condition.

In the commercial surety bond context, it is common for the surety to require some form of collateral from the principal prior to or contemporaneously with the surety's execution of the commercial surety bonds. In those instances, the surety has determined, either because of the financial condition of the principal or the nature and risk of the commercial surety bond obligation, that some form of collateral is necessary to either exonerate the surety prior to its payment of any loss under the commercial surety bonds or to reimburse the surety for its subsequent payments on the commercial surety bonds.

[4] The opinions and/or views set forth herein are not intended to be the opinions and views of the surety industry, any particular surety company, or Liberty Mutual Insurance Company or any of its affiliates, subsidiaries or parent entities.

[5] The Proverbs of the Aramean Ahikar (700 B.C.), No. 49.

If collateral is not required at the outset, future events and/or circumstances may cause the surety to demand collateral as a condition of continued commercial surety bonding for the principal in the future and/or to be "placed in funds" for the surety's forbearance from exercising its rights to cancel the existing commercial surety bonds. In this situation, as discussed below, having strong indemnity agreement provisions regarding collateral demand is important.

A. The Surety's Indemnity Agreement with its Principal.

Prior to executing commercial surety bonds for its principal, sureties generally require the principal (and possibly some indemnitors)[6] to execute some form of an indemnity agreement. The indemnity agreement may be a short form indemnity agreement based upon an application for the commercial surety bond, or may be a general indemnity agreement that covers numerous commercial surety bonds.[7]

At the underwriting stage, it is critical for the surety to realize that properly obtaining and securing the collateral, if not handled correctly at the outset as part of the issuance of the commercial surety bonds, may become very important at some point over the course of the relationship with the principal, particularly if the principal eventually files for bankruptcy. Accordingly, having specific terms in the indemnity agreement regarding collateral is a necessity that must not be overlooked. There are several indemnity agreement provisions regarding collateral that may be important in the bankruptcy context.

First, the indemnity agreement should expressly allow the surety to either "demand collateral" or to demand to be "placed in funds" at any time after the execution of the commercial surety bonds.[8] Such provisions are fairly standard in most indemnity agreement forms, but are rarely contained in the short form indemnity agreement provisions in commercial surety bond applications (where they are either non-existent or inadequate in many respects). A good "collateral demand" or "place in funds" provision should address the following issues:

- <u>Type of Collateral</u> – The surety should be able to demand any type of collateral at its sole discretion, and the provision should specifically reference irrevocable sight draft standby letters of credit;

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[6] While many surety indemnity agreements require the principal and certain indemnitors, whether individual or corporate indemnitors, to execute the indemnity agreement, this paper will only address the obligations of a principal to the surety under the indemnity agreement and will not address the issues that may arise with respect to any indemnitors. Many of the issues are the same, but it is a less complex presentation to limit this paper to a discussion of the collateral provided by the principal only rather than the surety's rights against the indemnitors and any collateral provided by the indemnitors.

[7] *See* SURETY INDEMNITY AGREEMENT, Chapter X at pp. 447-70.

[8] For the surety's right to demand collateral from the principal under the indemnity agreement, *see generally* SURETY INDEMNITY AGREEMENT at pp. 284-90 and pp. 469-70.

- Amount of Collateral - The amount of the collateral should be at the surety's sole discretion and should not be tied to or limited by the amount of any reserves the surety establishes;
- Coverage – The collateral demanded must cover all of the commercial surety bonds - current, past and future;
- Use of Collateral – The collateral must be available to pay losses, be held as a reserve against future claims, pay premiums, pay costs of consultants, attorneys and accountants, and to exonerate and/or reimburse the surety; and
- Return of Collateral – The provision should state the terms under which the collateral will be released and returned, i.e. after all potential risk of exposure for the surety has passed, and the commercial surety bonds released and discharged.

Second, the indemnity agreement should expressly state that it constitutes a security agreement and financing statement for purposes of the Uniform Commercial Code. This may allow the surety to obtain secured creditor status with respect to certain types of collateral, and may provide the surety with a priority and/or secured position in any future principal bankruptcy if the appropriate perfection steps are taken sufficiently in advance of the principal's filing for bankruptcy.

Third, the indemnity agreement should have a "power of attorney" or "attorney in fact" provision to allow the surety to execute documents on behalf of the principal such as agreements, checks, title documents, transfer documents, etc. This type of provision will allow the surety to take any necessary steps with respect to its collateral to secure, protect and preserve the surety's interest in the collateral and enforce the surety's rights under the indemnity agreement.

If the surety does not have the best terms and provisions in its indemnity agreement, the surety may still be able to compel the production of collateral through pure economic necessity. For example, if the principal needs continuing commercial surety bonding to operate its business, it may have little choice but to provide the collateral in exchange for the surety's agreement to continue to issue the commercial surety bonds and to refrain from cancelling the existing commercial surety bonds.

Notwithstanding the surety's rights to obtain collateral through the provisions of the indemnity agreement or as part of the underwriting process, the surety must next take the appropriate steps to enforce such provisions by acquiring the collateral and perfecting the surety's security interest in that collateral so that the surety may secure, preserve, protect and use the collateral as necessary.

B. Acquiring the Collateral and the Collateral Agreement.

The collateral that the surety obtains from its principal may take a number of forms, and the surety must take certain steps in acquiring the collateral to ensure that it

has good, valid, perfected rights in the collateral.[9] Frequently, a surety obtaining the collateral from the principal will require the principal to execute a "collateral agreement" in addition to the indemnity agreement. The collateral agreement will describe the collateral that the principal provides to the surety, define the surety's rights to the collateral (including the surety's rights to pay losses, to reimburse the surety for any losses the surety pays, to pay surety premiums, to pay the surety's attorneys' fees and expenses, etc.), and define the period of time in which the surety may retain the collateral and when the surety may be required to release the collateral.

It is preferable to obtain a collateral agreement in addition to the specific collateral terms in an indemnity agreement. The advantages of a collateral agreement over the terms of the indemnity agreement are that the collateral agreement can be more specific and detailed and can be tailored to the specific type of collateral involved or address any unique issues regarding specific forms of collateral. Indemnity agreements, on the other hand, tend to be more general and "institutionalized" as a document, the terms and conditions are not easily modified, and are not as focused on what happens to the collateral once it is obtained by the surety.

The following are various types of collateral that a surety may obtain from its principal whether before the commercial surety bonds are executed or after, and the general methods for perfecting the surety's rights in the collateral.

1. Letters of Credit as Collateral.[10]

The surety may receive a letter of credit from the principal as collateral for the commercial surety bonds. The Uniform Commercial Code ("UCC") defines letters of credit as:

> . . . an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor.

See UCC § 5-103.[11]

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9 *See generally* SURETY INDEMNITY AGREEMENT at pp. 130-56.

10 *See generally* SURETY INDEMNITY AGREEMENT at pp. 130-32.

11 In addition to Article 5 of the UCC, it is suggested that the reader review the Uniform Customs and Practice for Documentary Credits, Publication 600 (commonly referred to as the "UCP 600"), which is published by the International Chamber of Commerce ("ICC"), Commission on Banking Technique and Practice. The UCP 600 is frequently incorporated by reference into letters of credit and addresses certain aspects and issues related to presentment, honor and the banking standards for dealing with letters of credit. *See Ala. Textile Co. v. Chase Manhattan Bank, N.A.,* 982 F.2d 813, 816 (2d Cir. 1992); *W. Int'l Forest*

Historically, a letter of credit was a common payment mechanism in international trade that permitted the buyer in a transaction to substitute the financial integrity of a stable credit source, the bank that issues the letter of credit, for its own.[12] More recently, the letter of credit has been used more as a form of guarantee than as a form of payment. This more recent letter of credit form is referred to as a "standby" letter of credit and it is the form which sureties typically require as collateral. The standby letter of credit is used in a non-sales transaction as a guarantee against default on contractual obligations.[13] If the underlying contractual obligation is satisfied by the principal, the standby letter of credit will not be drawn upon.

In discussing the unique nature of letters of credit, one commentator observed:

> The linchpin of the letter of credit transaction is the unique legal relationship between the bank and the beneficiary. Unlike a guarantor, the bank is primarily liable whenever the beneficiary presents a draft and documents that conform to the letter. Unlike its counterpart in a third-party beneficiary contract, the bank may not invoke the defenses its customer might have on the underlying contract. 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. 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.

Baird, *Standby Letters of Credit in Bankruptcy*, Univ. of Chicago Law Review, Winter 1982, p. 134-135(citations omitted).

As discussed in this paper, in the bankruptcy context there are many advantages for a surety to obtain a letter of credit as the collateral from the principal instead of the principal's real or personal property as collateral. In addition to the favorable treatment in bankruptcy, letters of credit are a preferable form of collateral for other reasons as

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Prods., Inc. v. Shinhan Bank, 860 F.Supp. 151, 153 (S.D.N.Y. 1994); *MSF Holding Ltd. v. Fiduciary Trust Co. Intern.*, 435 F.Supp.2d 285, 293-294 (S.D.N.Y. 2006).

[12] *Bouzo v. Citibank, N.A.,* 96 F.3d 51, 56 (2d Cir. 1996) (quoting *Ala. Textile Co.,* 982 F.2d at 815); *accord All Serv. Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus Do Brazil, S.A., N.Y. Branch,* 921 F.2d 32, 34 (2d Cir. 1990).

[13] *Demczyk v. Mutual Life Ins. Co. (In re Graham Square, Inc.)*, 126 F.3d 823, 827-828 (6th Cir. 1997)(quoting Gerald T. McLaughlin, *Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy,* 43 OHIO ST. L.J. 1, 6 (1982)).

well. Letters of credit are considered to be liquid collateral. Sureties prefer liquid collateral in the form of the proceeds of a letter of credit as opposed to collateral that must be liquidated by a sale or transfer of the property. In addition to liquidity, letters of credit also have the advantage of not requiring any fees, expenses or transaction costs to receive the proceeds as opposed to other collateral which may have fees associated with a sale of or transfer of the collateral such as with real or personal property.[14] Finally, letters of credit are in fixed and known amounts, whereas other forms of personal or real property collateral have estimated values which can vary widely from the actual liquidated value upon sale and can fluctuate over time with economic and market conditions while the collateral is being held.

Letters of credit are generally issued with expiration dates.[15] However, many letters of credit are known as "evergreen," which means that the terms of the letter of credit permit its automatic renewal on a periodic basis.[16] Evergreen letters of credit generally permit the issuer to notify the beneficiary that the letter of credit will not renew for an additional period. If the letter of credit is not "evergreen" and is set to expire by its terms, or in the event that the issuer of the letter of credit provides notice to the surety as the beneficiary that the letter of credit will not be renewed, the surety may need to draw on the letter of credit and obtain the letter of credit proceeds rather than allow its collateral to disappear. The ability to draw on a letter of credit prior to its expiration solely to preserve the collateral points out the critical nature of having a letter of credit with no conditions on the surety's ability to make a draw on the letter of credit.

Ideally, the surety should seek to have its letter of credit state as follows, or with similar wording: "[t]his irrevocable letter of credit is not subject to any condition, qualification or contingency." If the letter of credit is conditioned on the existence of valid claims against or losses by the surety or other such terms before the issuing bank has to make payment, the surety may not be able to protect the collateral and may be forced to go back to the principal to negotiate for further or replacement collateral if the letter of credit is about to expire prior to the surety's right to draw on the letter of credit and obtain the proceeds.

A brief example can illustrate the issue. Assume that the surety is about to issue commercial surety bonds for its principal, a major nationwide retail distributor. As part of the underwriting, the surety demands collateral in the form of an "evergreen" letter of credit. The principal induces a major national bank to issue an "evergreen" irrevocable

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[14] Of course, the issuer of the letter of credit (usually a bank) will charge a fee to its customer, but the surety does not pay that fee.

[15] The UCC provides that "[i]f there is no stated expiration date or other provision that determines its duration, a letter of credit expires one year after its stated date of issuance or, if none is stated, after the date on which it is issued." UCC § 5-106 (c). The UCC further provides that "[A] letter of credit that states that it is perpetual expires five years after its stated date of issuance, or if none is stated, after the date on which it is issued." UCC § 5-106 (d).

[16] John F. Dolan, THE LAW OF LETTERS OF CREDIT, ¶ 5.03[3][b] n.232 (4th ed.2007); *Golden West Refining Co. v. SunTrust Bank*, 538 F.3d 1233, 1240 (9th Cir. 2008).

standby letter of credit to the surety. The letter of credit provides that it expires after a period of one year, but that it will automatically be extended for successive one year periods, unless at least 30 days prior to any expiration date the bank notifies the surety that the bank elects not to renew the letter of credit. The letter of credit also stipulates that the surety may make demand on the letter of credit upon presentment of a valid proof of claim from a claimant of the principal under a commercial surety bond or presentment of the surety's cancelled check evidencing payment of a claim arising from a commercial surety bond.

The letter of credit renews automatically for several years with no problem. Then the issuing bank, through its confidential financial dealings with the principal, learns that the principal is heading into financial trouble. At this point, the principal has been able to convince its suppliers and creditors to continue to deal with it and to work out new short term arrangements so there have not been any commercial surety bond claims, but the principal has a looming cash flow crisis coming. The issuing bank, realizing that the principal is in trouble, decides not to renew the letter of credit and notifies the surety that the letter of credit will not be renewed. In this scenario, 30 days after the bank's issuance of the notice, the letter of credit will expire and the surety, with no commercial surety bond claims or payments made, will have no collateral. Assuming that the surety receives the notice of non-renewal from the issuing bank and recognizes its importance, by the time the surety goes back to the principal, it may be too late for the surety to obtain any replacement collateral as the principal "circles the drain." The letter of credit expires because the surety is unable to satisfy the conditions of making a demand (i.e., it has not received any claims or made any payments), leaving the surety with no collateral. It is at this point that claims on the commercial surety bond will start arriving. If the letter of credit had no conditions or contingencies, the surety could have timely drawn down the entire amount of the letter of credit proceeds and placed the proceeds in a surety controlled account to serve as cash collateral for future claims.

The surety "perfects" its security interest in the letter of credit by control of the letter of credit.[17] The UCC defines control for purposes of letters of credit as follows:

> A secured party has control of a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under Section 5- 114(c) or otherwise applicable law or practice.

UCC § 9-107, Control of Letter-of-Credit Right.

2. Cash, Certificates of Deposit or Deposit Accounts as Collateral.[18]

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[17] *See* Uniform Commercial Code § 9-314.

[18] *See generally* SURETY INDEMNITY AGREEMENT at p. 132.

Cash, certificates of deposit and/or deposit accounts provided by the principal to the surety as collateral are normally considered to be the principal's property, even though they have been pledged as collateral.[19] While cash is definitely liquid, certificates of deposit may have penalties for early withdrawal and deposit accounts with various lenders, unless otherwise agreed with the surety, may be subject to the lender's set-off rights in the event the principal is indebted to the lender.

The UCC defines "deposit account" as a "demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument."[20] To perfect a security interest in deposit accounts, the surety must "control" the account.[21] The UCC defines control over a deposit account in relevant part as follows:

> (a) Requirements for control. A secured party has control of a deposit account if:
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> > (2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or
> > (3) the secured party becomes the bank's customer with respect to the deposit account.

UCC § 9-104.[22]

To perfect a security interest in cash or money, the surety must be in *possession* of the money.[23] Perfection by possession as is the case with perfection by control does not require a financing statement or any formal filing.[24] While the UCC does not expressly define "possession," the term has been held to mean exactly what it implies, namely that the secured party must have actual, physical possession of the cash or money in order to have a perfected security interest in that form of collateral.[25]

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[19] *See, e.g., Int'l Fin. Corp. v. Kaiser Group Int'l Inc. (In re Kaiser Group Int'l Inc.),* 399 F.3d 558, 566 (3d Cir. 2005); *In re S-Tran Holdings, Inc.,* 414 B.R. 28, 32 (Bankr. D.Del. 2009); *See In re Oakley*, 397 B.R. 36, 50 (Bankr. S.D.Ohio 2008); *In re MJK Clearing, Inc.*, 286 B.R. 862, 874 (Bankr. D.Minn. 2002); *In re Julien Co.*, 117 B.R. 910, 919 (Bankr. W.D. Tenn. 1990); 11 U.S.C. § 541 (c).

[20] *See* UCC § 9-102 (29).

[21] *See* UCC § 9-312 (b)(1).

[22] Section 1 of this provision deals with a bank's exercise of control over a customer's account.

[23] *See* UCC § 9-312 (b)(3) and § 9-313.

[24] *See* UCC § 9-313, comment 2.

[25] *See In re Wright Group, Inc.*, 443 B.R. 795, 804 (Bankr. N.D.Ind. 2011).

With respect to certificates of deposit, the question of perfection is fairly complicated and depends on the nature of the certificate of deposit, i.e., whether it is transferrable or negotiable and whether the particular jurisdiction will treat the certificate of deposit as a "deposit account" or an "instrument." In addition, the question of whether the certificate of deposit is "certificated" or "uncertificated" also impacts the analysis. The definition of a "deposit account" as noted above states that such accounts evidenced by Article 9 "instruments" are excluded from the definition. Thus, the definition of deposit accounts was intended to clarify the proper treatment of nonnegotiable or uncertificated certificates of deposit. The Official Comments of the UCC state that:

> Under the definition [of deposit account], an uncertificated certificate of deposit would be a deposit account (assuming there is no writing evidencing the bank's obligation to pay) whereas a nonnegotiable certificate of deposit would be a deposit account only if it is not an "instrument" as defined in this section (a question that turns on whether the nonnegotiable certificate of deposit is "of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment.")

UCC § 9-102, Official Comment 12 (clarification added).

A certificate of deposit evidenced by an instrument is subject to the rules applicable to perfection of instruments. The UCC § 9-312 (a) requires filing for the perfection of a security interest in instruments. To avoid any concerns regarding perfection of a security interest in a certificate of deposit, the surety should consider perfecting by exercising control as required for deposit accounts and by filing as required for instruments.

3. Other Collateral (real and personal property).[26]

In the event that the principal does not have liquid collateral in the form of a letter of credit, cash, certificates of deposit or deposit accounts, the surety may obtain collateral in the form of real or personal property.[27] With respect to the principal's real property, state law will provide how the surety obtains either a mortgage or deed of trust to secure its lien on the real property.[28] With respect to the principal's personal property (which could include equipment, inventory and materials, stocks and bonds and other financial investments, general intangibles, intellectual property, life insurance and other personal

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[26] *See generally,* SURETY INDEMNITY AGREEMENT at pp. 134-38.

[27] *See generally,* SURETY INDEMNITY AGREEMENT at pp. 139-47.

[28] *See generally,* SURETY INDEMNITY AGREEMENT at pp. 139-41.

property), the surety must perfect its interest in the personal property as collateral in accordance with state law, normally the UCC.[29]

Neither real property nor personal property is considered liquid. The surety must sell the real and/or personal property (with the attendant costs of sale) prior to obtaining the net funds necessary (assuming there is sufficient equity or value) to either pay a claim on a commercial surety bond or reimburse the surety for any payments the surety makes.[30] Furthermore, the real and/or personal property collateral may have prior liens on the collateral that reduce the equity (the net funds) available for the surety in the event it seeks reimbursement for any losses. In addition, as noted above, the value of the collateral is generally only an estimate that cannot be actually determined until after a sale of the property and such value can fluctuate over time with the economy and other market conditions. Finally, there are typically transaction costs associated with maintaining, selling or transferring most forms of real and personal property such as taxes, insurance, fees and expenses.

III. The Effect of the Principal's Bankruptcy Case on the Surety's Collateral.

When the principal files for bankruptcy and becomes a debtor-in-possession under chapter 11 of the Bankruptcy Code, a surety's rights in the collateral obtained from the principal may be subject to various provisions of the Bankruptcy Code. The surety must comply with the applicable provisions of the Bankruptcy Code prior to exercising its rights against the principal's (now the debtor's) collateral.

A. Property of the Principal's (the Debtor's) Estate (11 U.S.C. § 541).

Section 541 of the Bankruptcy Code provides that the commencement of a case under the Bankruptcy Code creates an estate.[31] The principal's estate is comprised of certain broadly defined property, "wherever located and by whomever held."[32] Specifically, the property of the bankruptcy estate includes all of the principal's legal or equitable interests in property as of the commencement of the bankruptcy case and also includes proceeds or profits of or from the property of the estate.[33] "The intent of this provision [§ 541(a)(1)] is to include all property rights of the Debtor, even if the property

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[29] *See generally,* SURETY INDEMNITY AGREEMENT at pp. 141-46 and pp. 307-22.

[30] *See generally,* SURETY INDEMNITY AGREEMENT at pp. 151-55.

[31] 11 U.S.C. § 541 (a).

[32] *Id.*

[33] *Id.* § 541 (a)(1) and (6).

right is contingent."[34] Thus, the "conditional, future, speculative, or equitable nature" of an interest does not prevent it from becoming property of the bankruptcy estate.[35]

The legislative history of the Bankruptcy Code reveals that the concept of "property of the estate" is to be interpreted broadly.[36] The Supreme Court has affirmed that the scope of § 541(a) is broad, covering all kinds of property, including tangible or intangible property, causes of action and all other forms of property.[37] Notwithstanding the broad interpretation, however, the debtor's interests in an asset or its rights against others are not expanded by the filing of a bankruptcy proceeding.[38] "To the extent that the legal or equitable interest of the debtor in property is limited in the debtor's hands, it is equally limited as property of the estate."[39]

Bankruptcy law defines what property is included in the estate, but state law generally determines whether a debtor has a legal or equitable interest in property for purposes of § 541 and the extent of such interest.[40] The principal's cash, certificates of deposit, deposit accounts, real property and personal property will most likely be deemed property of the principal's bankruptcy estate and be subject to the remaining provisions of the Bankruptcy Code, such as the automatic stay as described below.[41] However, also as described below, a letter of credit and the proceeds of the letter of credit are generally *not* considered to be property of the principal's estate. This characteristic of letters of credit make them a very valuable form of collateral for the surety to have in the bankruptcy context.

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[34] *In re Palmer*, 167 B.R. 579, 585 (Bankr. D.Ariz. 1994) (clarification added), *citing Neuton v. Danning,* 922 F.2d 1379, 1382–1383 (9th Cir. 1990).

[35] *In re Anders*, 151 B.R. 543, 545 (Bankr. D.Nev. 1993); *In re Anderson,* 128 B.R. 850 (D.R.I.1991).

[36] *See* H.R.Rep. No. 595, 95th Cong., 1st Sess. 367–68 (1977), *reprinted in* U.S.C.C.A.N. 5787, 5963, 6323–24.

[37] *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 204–05 & n. 9, 103 S.Ct. 2309, 2314 & n. 9, 76 L.Ed.2d 515 (1983).

[38] *Matter of Sanders,* 969 F.2d 591 (7th Cir.1992); *Matter of Village Rathskeller, Inc.,* 147 B.R. 665 (Bankr.S.D.N.Y.1992); *In re Squyres*, 172 B.R. 592, 594 (Bankr. C.D.Ill. 1994).

[39] *In re Squyres*, 172 B.R. at 594 (Bankr. C.D.Ill. 1994), *citing In re Balay,* 113 B.R. 429 (Bankr. N.D.Ill. 1990).

[40] *See Butner v. United States,* 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979); *In re Thomas,* 883 F.2d 991, 995 (11th Cir. 1989); *In re Moore*, 448 B.R. 93, 99-100 (Bankr. N.D.Ga. 2011); *In re Bell,* 279 B.R. 890, 895 (Bankr. N.D.Ga. 2002).

[41] *Whiting Pools, Inc*., 462 U.S. 198; *In re Moore*, 448 B.R. at 100.

B. Automatic Stay (11 U.S.C. § 362).

Section 362 of the Bankruptcy Code provides that the filing of a petition and the commencement of the bankruptcy case operates as a stay of virtually all actions, applicable to all entities, including the surety.[42] Upon the commencement of the principal's bankruptcy case, a surety may not enforce its rights against the principal's property without risking a violation of the automatic stay. The automatic stay remains in effect until the principal's property is no longer the property of the principal's estate.[43] A violation of the automatic stay can result in sanctions, assessment of damages, attorney fees and even punitive damages.[44] Moreover, any action taken in violation of the automatic stay is void and without effect.[45] "A 'willful violation' of the stay does not require a specific intent to violate the automatic stay. Rather, the statute provides for damages upon a finding that the defendant knew of the automatic stay and that the defendant's actions which violated the stay were intentional. Whether the party believes

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[42] 11 U.S.C. § 362(a) provides that the automatic stay prohibits creditors from taking the following actions against a debtor or its property:

> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
> (4) any act to create, perfect, or enforce any lien against property of the estate;
> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
> (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

[43] 11 U.S.C. § 362(c).

[44] 11 U.S.C. § 362(h).

[45] *Franklin Sav. Ass'n v. Office of Thrift Supervision*, 31 F.3d 1020, 1022 (10th Cir. 1994), *citing Ellis v. Consol. Diesel Elec. Corp.,* 894 F.2d 371, 372–73 (10th Cir. 1990); *Kalb v. Feuerstein,* 308 U.S. 433, 438, 60 S.Ct. 343, 345–46, 84 L.Ed. 370 (1940); *In re Advent Corp.,* 24 B.R. 612, 614 (1st Cir. BAP 1982); *In re Young*, 14 B.R. 809, 811 (Bankr. N.D.Ill. 1981). Acts done in violation of the stay are void ab initio regardless of lack of knowledge of the filing of the petition. *In re Wariner*, 16 B.R. 216, 218 (Bankr. N.D.Tex. 1981); *In re Miller*, 10 B.R. 778, 780 (Bankr. D.Md. 1981).

in good faith that it had a right to the property is not relevant to whether the act was 'willful' or whether compensation must be awarded."[46]

A surety may seek relief from the automatic stay in order to enforce its rights against the principal's property that serves as the surety's collateral. After notice and a hearing, the bankruptcy court may provide relief, such as by terminating, annulling, modifying or conditioning the automatic stay, for the following reasons:

- For cause, including the principal's lack of adequate protection of the surety's interest in the principal's property;[47] or

- With respect to a stay of any act against the property of the principal's estate, if the principal does not have any equity in the principal's property that serves as the surety's collateral and the surety's collateral is not necessary to an effective reorganization.[48]

It is the surety's burden of proof on the issues of cause and/or whether the principal has any equity in the principal's property that serves as the surety's collateral.[49]

IV. The Surety's Right and Ability to Use the Surety's Collateral After the Principal Files for Bankruptcy.

Because of the effect of the Bankruptcy Code's provisions on the surety's collateral, the surety must analyze the surety's collateral to determine the surety's right and ability to use the collateral after the principal files its bankruptcy case. The issue of whether the surety's collateral is deemed to be property of the principal's bankruptcy estate, and therefore subject to the automatic stay, is critical. This is highlighted by the different ways that the Bankruptcy Code and the bankruptcy case law decisions treat letters of credit as the surety's collateral as opposed to other surety collateral which is deemed to be property of the principal's bankruptcy estate.

A. Letters of Credit as the Surety's Collateral in Bankruptcy.

Because letters of credit and the proceeds of letters of credit are not deemed to be property of the principal's bankruptcy estate under section 541 of the Bankruptcy Code, and therefore the automatic stay under section 362 is not deemed to be in effect with respect to the surety's rights to draw against the letter of credit and obtain and use the

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[46] *Pinkstaff v. United States (In re Pinkstaff),* 974 F.2d 113, 115 (9th Cir. 1992), *quoting Goichman v. Bloom (In re Bloom),* 875 F.2d 224, 227 (9th Cir. 1989)).

[47] 11 U.S.C. § 362(d)(1).

[48] 11 U.S.C. § 362(d)(2).

[49] 11 U.S.C. § 362(g)(1).

letter of credit proceeds, letters of credit from the principal are considered to be the best form of surety collateral for its execution of commercial surety bonds. As a result, the following is a more detailed discussion of letters of credit as the surety's collateral in the principal's bankruptcy case.

1. Nature and Purpose of Letters of Credit.

A letter of credit is typically defined as "an engagement by an issuer, usually a bank, made at the request of a customer for a fee, to honor a beneficiary's drafts or other demands for payment upon satisfaction of the conditions set forth in the letter of credit."[50] A letter of credit arises from a transaction involving three separate contracts.[51] The first contract generally arises between a buyer and a seller. In the surety context, the principal, by offering its indemnity to the surety under the indemnity agreement, requests that the surety issue commercial surety bonds to various of the principal's creditors/obligees to allow the principal to pursue its business operations and goals. The second contract arises between the account party or customer, the principal, and the issuer of the letter of credit, typically a bank. Finally, the third contract arises between the issuer, the bank, and the beneficiary of the letter of credit, the surety. "The relationship between each pair of parties involved in a letter of credit transaction is entirely independent, although each relationship is necessary to support a letter of credit, somewhat like the three legs of a tripod."[52]

The letter of credit basically serves the purpose of shifting risk. The risk that the principal will not be able to exonerate and/or reimburse the surety for losses under the indemnity agreement is shifted from the surety to the issuing bank by means of the letter of credit.[53]

2. Independence Principle – Letters of Credit and Their Proceeds Are Not Property of the Estate Under 11 U.S.C. § 541.

The independent nature of each of the three contracts involved in a letter of credit transaction is known as the "independence principle," and this principle seeks to preserve the viability of letters of credit, whose commercial purpose is to allow the beneficiary to draw on the money before obtaining a judgment. Indeed, it has been observed that "[t]he salient feature of a letter of credit and the principal reason for its use in commercial

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[50] *Tudor Dev. Group, Inc. v. United States Fid. & Guar. Co.*, 968 F.2d 357, 360 (3rd Cir. 1992).

[51] *Demczyk v. Mutual Life Ins. Co. (In re Graham Square)*, 126 F.3d 823, 827 (6th Cir. 1997).

[52] *P.A. Bergner & Co. v. Bank One, N.A. (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1114 (7th Cir. 1998), *cert. denied* 525 U.S. 964 (1998).

[53] *Kellogg v. Blue Quail Energy, Inc. (In re: Compton Corp).,* 831 F.2d 586, 590 (5th Cir. 1987); *In re North Shore,* 30 B.R. at 378.

transactions is the 'independence principle,'"[54] and strict adherence to this principle "is necessary to protect the integrity of letters of credit as a valuable commercial tool."[55]

The independence principle has been codified in the UCC. UCC § 5-103 provides:

> (d) Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

UCC § 5-103 (d).

The independence principle insulates the letter of credit from disputes over performance of collateral agreements between the principal and the issuer and allows the letter of credit to function as a swift and certain payment mechanism.[56]

As a result of the independence principle, letters of credit and their proceeds are generally not part of the principal's bankruptcy estate because the bank issuing the letter of credit to the surety distributes *the bank's own assets* to the surety upon the surety's demand on the letter of credit and *not* the assets of the principal/customer who caused the letter of credit to be issued.[57] Thus, the proceeds of the letter of credit, which come into the possession of the surety upon the surety's demand and the issuing bank's payment, are assets of the bank, and as such are not the principal's assets or property. It is because of the independence principle that the majority of courts recognize and hold that the proceeds from a letter of credit do not constitute property of the principal/debtor's estate under 11 U.S.C. § 541.[58]

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[54] *Tudor Dev. Group*, 968 F.2d at 360.

[55] *In re Prime Motor Inns, Inc.*, 130 B.R. 610, 613 (S.D. Fla. 1991); *In re War Eagle Const. Co.,* Inc., 283 B.R. 193 (S.D. W.Va. 2002).

[56] *In re Graham Square,* 126 F.3d at 827; *In re: Compton,* 831 F.2d 589; *In re W.L. Mead, Inc.,* 42 B.R. 57 (Bankr.N.D.Ohio 1984); *In re M.J. Sales & Distrib. Co.,* 25 B.R. 608 (Bankr.S.D.N.Y. 1982).

[57] *See In re Metro Commc'ns, Inc.,* 115 B.R. 849, 854 (Bankr. W.D. Pa. 1990); *In re Compton,* 831 F.2d 590; *In re Leisure Dynamics, Inc.,* 33 B.R. 171 (Bankr. Minn. 1983); *In re M.J. Sales*, 25 B.R. 608; *In re Spring Ford Indus., Inc.,* 338 B.R. 255 (Bankr. E.D. Pa. 2006).

[58] *See Willis v. Celotex Corp.*, 978 F.2d 146, 148 n. 3 (4th Cir. 1992); *(In re Compton)*, 831 F.2d, 589; *In re Oakwood Homes Corp.*, 342 B.R. 59 (Bankr. D. Del. 2006); *In re Spring Ford Indus., Inc.*, 338 B.R. 255 (Bankr. E.D. Pa. 2006); *In re Stonebridge Techs., Inc.*, 430 F.3d 260 (5th Cir. 2005); *In re W.L. Mead, Inc.*, 42 B.R. 57 (Bankr. Ohio 1984); *In re Leisure Dynamics, Inc.*, 33 B.R. 171 (Bankr. Minn. 1983); *In re North Shore & Cent. Ill. Freight Co.*, 30 B.R. 377 (Bankr. N.D. Ill. 1983); *In re M.J. Sales*, 25 B.R. 608; *In re Zenith Labs., Inc.*, 104 B.R. 667 (Bankr. D.N.J. 1989); *In re Farm Fresh Supermarkets of Md., Inc.*, 257 B.R. 770 (Bankr. D.Md. 2001); *In re Hechinger Inv. Co. of Del., Inc.*, 282 B.R. 149 (Bankr. D.Del. 2002); *In re Kmart Corp.*, 297 B.R. 525 (N.D.Ill. 2003); *In re War Eagle Const. Co., Inc.*, 283 B.R.

Because of the independence principle, the sole duty of the issuer of a letter of credit is ministerial; namely, the issuer has to determine if the beneficiary has properly complied with the conditions in the letter of credit and once the beneficiary fulfills the requirements of the letter of credit and draws on it, the issuer of the letter of credit cannot direct how the beneficiary uses the proceeds.[59] After the issuing bank pays the funds to the beneficiary, the letter of credit is a fully executed contract, and the issuing bank must look to its customer for repayment just as would any other creditor.[60]

3. Letters of Credit and the Automatic Stay (11 U.S.C. § 362).

Because the letter of credit and its proceeds are not considered to be property of the estate, the automatic stay as provided by § 362 of the Bankruptcy Code does not apply to a beneficiary's draw request on the letter of credit or the issuing bank's payment of the beneficiary's request.[61]

The case of *In re North Shore & Central Illinois Freight Co.*, 30 B.R. 377 (Bankr. Ill. 1983) is illustrative of the unique nature of letters of credit and the inapplicability of the automatic stay. The debtor arranged for a $50,000.00 letter of credit with a bank.[62] The beneficiary of the letter of credit was a surety, Protective Insurance Company. The letter of credit was issued to provide Protective with adequate security against any liability it might incur while serving as surety for the debtor. Subsequently, the debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Thereafter, Protective sought to draw the $50,000.00 from the bank as permitted under the terms of the letter of credit. The debtor then filed an adversary complaint in the bankruptcy court against the Protective and the issuing bank seeking to prevent the bank from disbursing the funds to Protective. Protective moved to dismiss the debtor's complaint. Thus, the issue before the Court was "whether the debtor's bankruptcy affects the right of Protective to draw upon the letter of credit."[63]

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193 (Bankr. S.D.W.Va. 2002); *In re Baja Boats, Inc.*, 203 B.R. 71 (Bankr. N.D.Ohio. 1996); *In re Milford Group, Inc.*, 197 B.R. 31 (Bankr. M.D.Pa. 1996); *In re Duplitronics, Inc.,* 183 B.R. 1010 (Bankr. N.D.Ill. 1995); *In re San Jacinto Glass Indus., Inc.*, 93 B.R. 934 (Bankr. S.D.Tex. 1988); *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293 (11th Cir. 1988); *In re Elegant Merch., Inc.*, 41 B.R. 398 (Bankr. S.D.N.Y. 1984); *In re Pine Tree Elec. Co.*, 34 B.R. 199 (Bankr. D.Me. 1983); *Matter of Planes, Inc.*, 29 B.R. 370 (Bankr. N.D.Ga. 1983).

[59] *See In re Eastern Freight Ways, Inc.,* 9 B.R. 653, 662 (Bankr. S.D.N.Y. 1981).

[60] *Id.* at 662; *In re Lancaster Steel Co.,* 284 B.R. 152, 160 (Bankr. S.D. Fla. 2002).

[61] *In re Illinois-California Exp., Inc.*, 50 B.R. 232, 235 (Bankr. Colo. 1985), *citing In re Elegant Merch., Inc.*, 41 B.R., 399; *In re North Shore & Cent. Ill. Freight Co.*, 30 B.R. 377; *In re Page*, 18 B.R. 713 (Bankr. D.D.C.1982); *In re M.J. Sales*, 25 B.R. 608; *In the Matter of Planes, Inc.*, 29 B.R. 370 (Bankr. N.D.Ga. 1983); *In re Clothes, Inc.*, 35 B.R. 487 (Bankr. D.N.D. 1983).

[62] *Id.* at 377.

[63] *Id.* at 378.

The debtor argued that the automatic stay of the Bankruptcy Code prevented Protective from drawing upon the letter of credit. Implicit in the debtor's argument was the proposition that the letter of credit was property of the debtor's estate. The Court noted that the automatic stay was inapplicable to property which was not part of debtor's estate pursuant to § 541 of the Bankruptcy Code.[64] In analyzing the issue, the *North Shore* Court recognized the important function that letters of credit play in the commercial marketplace and that the bank issuing the letter of credit is the party obligated to the beneficiary, not the debtor.[65] The Court observed:

> The transaction involved in this controversy resembles a standby letter of credit arrangement. Under a standby letter of credit arrangement the bank becomes primarily liable to the beneficiary upon the default of the bank's customer. In return the bank charges the customer a fee based upon the customer's probability of insolvency. It is argued that this arrangement spreads the allocation of risk to the parties who are best able to ascertain the risk.

Id. at 378.

Accordingly, the *North Shore* Court held that the letter of credit was not property of the bankruptcy estate and the automatic stay did not bar the surety's draw down of the letter of credit.[66]

The United States Bankruptcy Court for the Eastern District of Virginia has also recognized that letters of credit are not property of the bankruptcy estate and are not subject to the automatic stay.[67] In *In re Printing Department, Inc.,* 20 B.R. 677 (Bankr. E.D. Va. 1981), the debtor moved for an order showing cause why the beneficiary of a letter of credit should not be found in contempt based on an alleged violation of the automatic stay to prevent the beneficiary from drawing down on a letter of credit and to seek recovery of any moneys paid under the letter of credit.

The *Printing Department* Court observed that a "letter of credit" is "an engagement by a bank or other person made at the request of a customer... that the issuer will honor drafts or other demands for payment upon compliance with the conditions

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[64] *Id. citing Globe Constr. Co. v. Oklahoma City Hous.,* 571 F.2d 1140, 1143 (10th Cir. 1978), *cert. denied* 439 U.S. 835, 99 S.Ct. 117, 58 L.Ed.2d 131 (19.79).

[65] *Id.*

[66] *Id.* at 379. *See also In re M.J. Sales*, 25 B.R. 608.

[67] *In re Printing Depart., Inc.,* 20 B.R. 677 (Bankr E.D. Va. 1981); *In re Valley Vue Joint Venture,* 123 B.R. 199 (Bankr E.D. Va. 1991).

specified in the credit . . ."[68] Further, the Court noted that under the UCC, the issuer of a letter of credit "must honor a demand for payment which complies with the terms of a letter of credit regardless of compliance with the underlying contract."[69] The *Printing Department* Court concluded that, "the issuer of the letter of credit, therefore, assumes an original primary obligation wholly apart from the underlying contract which exists between the beneficiary and the customer."[70] Thus, the *Printing Department* Court held that when the creditor submitted its draft to the issuing bank, it was not asserting a claim against the debtor or against any of the estate's property; rather, it was enforcing a contract which existed between the creditor and the bank that issued the letter of credit, which was independent of any relationship between debtor and the issuing bank.[71]

The Court stated, "[T]he issuer of a letter of credit 'acts as a principal, not as agent for its customer, and engages its own credit.' . . . That obligation is fully independent of any underlying agreement. This independence from any underlying agreement allows banks to negotiate letters of credit freely without facing the risks which could arise on an ordinary contract."[72] The *Printing Department* Court held that letters of credit are not property of the estate and as such the automatic stay does not apply and the debtor's claimed relief was denied.

4. Letters of Credit and Turnover Powers Under 11 U.S.C. § 542.

Because the letter of credit and its proceeds are generally not considered to be property of the estate, many of the rights and powers of the bankruptcy trustee or debtor in possession do not apply to the letter of credit or its proceeds. One such trustee/debtor in possession right under the Bankruptcy Code is the right of "turnover" as provided by 11 U.S.C. § 542. Such a remedy is not applicable to the proceeds of a letter of credit because such proceeds are not property of the estate.[73] Section 542 of the Bankruptcy Code provides in relevant part:

> (a) . . . an entity, . . . in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such

[68] *Id.* at 679.

[69] *Id.* at 680.

[70] *Id.* at 681.

[71] *Id.*

[72] *Id. citing Dullen Steel Prods. v. Bankers Trust Co.,* 189 F.Supp. 922, 927 (S.D.N.Y. 1960), *aff'd* 298 F.2d 836 (2d Cir. 1962) and Verkull, BANK SOLVENCY AND GUARANTY LETTERS OF CREDIT, 25 Stan.L.Rev. 716, 720 (1973).

[73] *Hechinger Inv. Co. of Del., Inc. v. Allfirst Bank (In re Hechinger Inv. Co. of Del., Inc.)*, 282 B.R. 149, 161 (Bankr. D. Del. 2002).

> property, unless such property is of inconsequential value or benefit to the estate.
>
> (b) . . . an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

11 U.S.C. § 542.

Implicit in the bankruptcy concept of turnover is the idea that the property being sought is clearly the property of the debtor, but not in the debtor's possession.[74] Turnover under § 542 is a remedy available to debtors to obtain what is acknowledged to be property of the bankruptcy estate.[75] It is not a remedy available to recover claimed debts which remain unliquidated and/or in dispute.[76] Thus, it has been held that under the Bankruptcy Code a bankruptcy court may generally order a third party to turn property in its possession over to the debtor's estate if the following three primary requirements are met:

> First, such property must be 'property of the estate.' Second, at the moment the debtor filed a petition, the debtor must have had the right to use, sell, or lease the property. Finally, upon request, the court must ensure that the third party's interest in the property is adequately protected.

In re Lewis, 137 F.3d 1280, 1282 (11th Cir. 1998).

In *Hechinger Investment Co. of Delaware, Inc. v. Allfirst Bank (In re Hechinger Investment Co. of Delaware, Inc.),* 282 B.R. 149 (Bankr. D.Del. 2002), the debtor arranged for the issuance of a letter of credit to its pre-bankruptcy lender as part of a post-bankruptcy agreement with its pre-bankruptcy lender to allow a pre-petition deposit account to remain open. After being notified that the letter of credit would not be renewed, the beneficiary of the letter of credit drew down the entire amount of the letter of credit. The Chapter 11 debtor brought an adversary proceeding against the beneficiary of the letter of credit (defendant) alleging that the draw on the letter of credit was improper and asserting that the letter of credit proceeds in the possession of the defendant were property of the estate to which the debtor was entitled to turnover pursuant to § 542.

The defendant moved to dismiss the turnover count of the adversary complaint asserting that the proceeds of the letter of credit did not constitute property of the debtor's estate as the funds issued from the letter of credit belonged to the issuing bank and not to

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[74] *See FLR Co. v. United States (In re FLR Co.),* 58 B.R. 632, 634 (Bankr. W.D.Pa. 1985).

[75] *See In re Hechinger*, 282 B.R. at 160-162 (Bankr. D.Del. 2002), *citing In re Asousa P'ship.,* 264 B.R. 376, 384 (Bankr. E.D.Pa. 2001); *In re Rosenzweig,* 245 B.R. 836, 839–40 (Bankr. N.D.Ill. 2000).

[76] *See In re Oakwood Homes Corp.*, 342 B.R. at 67-69 (Bankr. D.Del. 2006).

the debtor who caused the letter of credit to be issued. The debtor countered that the letter of credit proceeds constituted property of the estate in the possession of defendant because the debtor had an alleged equitable interest in its claim to the return of the funds as funds improperly debited from its account and because the debtor had an alleged equitable interest in the issuing bank's claim for breach of contract against the defendant arising out of defendant's allegedly inaccurate certification under the letter of credit.

The *Hechinger* Court observed that "it is well settled that the proceeds from a letter of credit do not constitute property of the estate under § 541. Therefore, such proceeds, . . . , are not subject to turnover under § 542 as property that the Debtor 'may use ... under section 363.'" The Court further noted, "[t]he fact that Debtor may have equitable interests in certain breach of contract claims which seek to recover the . . . [letter of credit proceeds], which interests constitute property of the estate, does not alter the result." Accordingly, the Court granted the motion to dismiss the turnover count.

5. Letters of Credit and Preference Avoidance Powers Under 11 U.S.C. § 547.

The trustee/debtor in possession preference avoidance powers as provided by 11 U.S.C. § 547 do not apply to the letter of credit or its proceeds because such they generally not considered to be property of the debtor's estate.

Section 547 of the Bankruptcy Code requires that in order for a transfer to be subject to avoidance as a preference: (1) there must be a transfer of an interest of the debtor in property, (2) on account of an antecedent debt, (3) to or for the benefit of a creditor, (4) made while the debtor was insolvent, (5) within 90 days prior to the commencement of the bankruptcy case, (6) that left the creditor better off than it would have been if the transfer had not been made and the creditor had asserted its claim in a Chapter 7 liquidation.[77] As the foregoing elements demonstrate, for a transfer to be avoided under section 547, "it is essential that the debtor have an interest in the property transferred so that the estate is thereby diminished."[78] The purpose of the preference avoidance powers is to discourage creditors from "racing to the courthouse to dismember the debtor during his slide into bankruptcy," and to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor."[79] The preference powers under the Bankruptcy Code are subject to certain defense as set forth in the Bankruptcy Code. Chief among those defenses are transfers that are made for new value or in the ordinary course of business.[80]

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[77] *See In re Interior Wood Prodts. Co.*, 986 F.2d 228, 230 (8th Cir. 1993); *In re Jet Florida Systems, Inc.,* 861 F.2d 1555, 1558 n. 2 (11th Cir.1988); *Brown v. First Nat'l Bank,* 748 F.2d 490, 491 (8th Cir.1984) (citing *DeAngio v. DeAngio,* 554 F.2d 863, 864 (8th Cir.1977)).

[78] *Coral Petroleum, Inc. v. Banque Paribas–London,* 797 F.2d 1351, 1355–1356, *reh'g denied,* 801 F.2d 398 (5th Cir.1986); *In re Grabill Corp.*, 135 B.R. 101, 107 (Bankr. N.D.Ill. 1991).

[79] *In re Issac Leaseco, Inc.*, 389 F.3d 1205, 1209 (11th Cir. 2004).

[80] 11 U.S.C.A. § 547 (c) *et seq.*

In *Wooten v. U.S. Through Dept. of Interior*, 56 B.R. 227 (W.D.La. 1985), the Court held that because letters of credit are not property of the debtor's estate, the trustee's preference avoidance powers under 11 U.S.C. § 547 do not apply. The debtor was an oil refining company that entered into a contract for the purchase of crude oil from the Department of the Interior ("Department").[81] The contract was secured by letters of credit issued by a bank in favor of the Department. The contract was terminated by the Department because the debtor failed to pay for oil deliveries. The Department then drew down on the letters of credit both before and after the debtor had filed for bankruptcy. Among other assertions, the trustee alleged that the draw downs on the letters of credit constituted preferences under 11 U.S.C. § 547.[82]

The Department sought dismissal of the trustee's preference claims on grounds that letters of credit are neither property of the debtor nor property of the bankruptcy estate. The *Wooten* Court noted that a letter of credit and its proceeds are property of the issuing bank, not the debtors.[83] The court explained as follows:

> In issuing the letter of credit the Bank entered into an independent contractual obligation to pay [beneficiary of the letter of credit] out of its own assets. Although cashing the letter will immediately give rise to a claim by the Bank against the debtors pursuant to the latter's indemnification obligations, that claim will not divest the debtors of any property since any attempt to enforce that claim would be subject to an automatic stay.[84]

The *Wooten* Court held that "[n]o avoidable transfer occurred because the assets of [the bank], rather than those of [the debtor], were depleted. Thus, the trustee's claim pursuant to 11 U.S.C. § 547 is dismissed for failure to state a cause of action."[85]

Similarly, in *In re Illinois-California Exp., Inc.*, 50 B.R. 232 (Bkrtcy. Colo. 1985), the Court held that the preference avoidance powers of the trustee do not apply to letters of credit. In *Illinois-California Exp.,* the debtor entered into a loan credit agreement with various banks under which the banks agreed to issue letters of credit, secured by the property of the debtor, for the benefit of Liberty Mutual Insurance Company.[86] Under the terms of the letters of credit, Liberty Mutual would draw on the letters of credit as

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81 *Id.* 56 B.R. at 228.

82 *Id.*

83 *Id.* at 231-232.

84 *Id.* at 232, *citing In re Page,* 18 B.R. 713, 715–16 (Bankr. D.D.C. 1982).

85 *Id.* (clarification added).

86 *Id.* 50 B.R. at 233.

necessary in order to pay loss and damage claims filed against the debtors by third parties.[87] The letters of credit were all issued prior to the filing of the bankruptcy. Liberty Mutual made several draws against the letters of credit both before and after the bankruptcy was filed. The trustee filed a complaint against the banks and Liberty Mutual alleging among other claims that the draws on the letters of credit were voidable preferences. The banks and Liberty Mutual moved to dismiss the complaint.[88]

In addressing the motion to dismiss the preference claims, the *Illinois-California Exp.* Court noted that the "overwhelming authority" of the law indicates that money advanced under a letter of credit is not property of the debtor's estate.[89] The Court observed that a letter of credit creates a separate and distinct obligation between the issuer and the beneficiary in which the issuer obligates itself to honor all drafts of the beneficiary which are presented in compliance with the letter of credit and that when the issuer honors a proper draft, it does so from its own assets and not from the assets of the customer.[90] The Court stated that "[t]he Bankruptcy Court's jurisdiction does not extend to control property in which the debtor has no property interest."[91] Accordingly, the *Illinois-California Exp.* Court granted the motion to dismiss and held that because the letters of credit are not property of the estate nor property of the debtor the trustee had no legal claims.

6. Letters of Credit and Post-Petition Transfer Powers Under 11 U.S.C. § 549.

Section 549 of the Bankruptcy Code provides that the trustee in bankruptcy may avoid an unauthorized post-petition transfer of property of the debtor's estate.[92] The Bankruptcy Code states as follows:

> (a) Except as provided in subsection (b) or (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 only under section 303(f) or 542(c) of this title; or
> (B) that is not authorized under this title or by the court.

11 U.S.C. § 549.[93]

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[87] *Id.*

[88] *Id.*

[89] *Id.* 50 B.R. at 239.

[90] *Id.* at 240 *quoting In re W.L. Mead,* 42 B.R. 57 (Bankr. N.D.Ohio 1984).

[91] *Id. citing Jordan v. Randolph Mills, Inc.,* 29 B.R. 398 (Bankr. M.D.N.C. 1983); *In re Dr. C. Huff Co., Inc.,* 44 B.R. 129 (Bankr. W.D.Ky. 1984).

[92] 11 U.S.C.A. § 549.

Accordingly, to avoid a transfer under § 549, it must be demonstrated that: (1) a transfer occurred; (2) of property of the estate; (3) which occurred post-petition; and (4) was not authorized by the Bankruptcy Code or the court.[94] Unlike other avoidance powers, the question of "diminution of estate" is not relevant. Although the primary purpose of § 549 is to allow the avoidance of post-petition transfers of property which deplete the estate, the inability to demonstrate a measurable depletion of the estate is not enough to allow a transfer to stand when it is otherwise avoidable under § 549.[95] Once a court finds a transfer avoidable, Section 550(a) allows the trustee to recover the property transferred.[96]

In *In re M.J. Sales & Distributing Co.,* 25 B.R. 608 (Bankr. S.D.N.Y. 1982), Aetna Casualty & Surety Company (Aetna) issued an "open default" bond on behalf of the principal in favor of a claimant as a condition for a state court vacating an earlier entered order of default against the principal. The bond assured payment of any future judgment against the principal. With the posting of the bond, the state court action between the principal and the claimant proceeded as a contested action.

As a condition of issuing the bond, Aetna required that its principal obtain a letter of credit as collateral. The letter of credit was issued by a bank and the principal provided a treasury bond to the bank as security for the bank's issuance of the letter of credit. Subsequently, the principal filed for bankruptcy. The claimant obtained relief from the automatic stay to allow the state court action to proceed; however, the principal's counsel withdrew and the principal was in danger of being in default again. Accordingly, Aetna made demand on the bank to draw on the letter of credit. Ultimately, a default judgment was entered against the principal and the claimant filed suit against Aetna to collect on the bond. The trustee sought to enjoin the bank and Aetna from drawing on the letter of credit asserting among other things that § 549 barred such action.

The *M. J. Sales* Court noted that a bank honors a letter of credit and pays the beneficiary with its own funds, and not with assets belonging to the debtor.[97] The Court stated, "[i]t is clear that the funds from which [the bank] must honor the letter of credit do

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[93] The Bankruptcy Code provides only two exceptions to a trustee's § 549 avoiding power, which are not typically relevant in the surety collateral context. First, subsection (b), which involves only involuntary bankruptcy cases, and second, subsection (c), which protects good faith purchasers of real property.

[94] *See Manuel v. Allen,* 217 B.R. 952, 955 (Bankr. M.D.Fla. 1998).

[95] *In re Straightline Inves., Inc.*, 525 F.3d 870, 878 -879 (9th Cir. 2008), *citing* 5 Lawrence P. King, *Collier on Bankruptcy* § 549.02 (15th ed. 2005).

[96] *See In re Delco Oil, Inc.,* 599 F.3d 1255, 1258-1259 (11 Cir. 2010); 11 U.S.C. § 550(a)("[T]o the extent that a transfer is avoided under section ... 549 ... the trustee may recover, for the benefit of the estate, the property transferred, or if the court so orders, the value of such property, from-(1) the initial transferee of such transfer....").

[97] *Id.* 25 B.R. at 614.

not constitute property of the estate. (citation omitted) Hence, there are no provisions under the Bankruptcy Code that would prevent payment to Aetna pursuant to the letter of credit.[98]

7. Excess Proceeds from a Letter of Credit

In the event that the surety has drawn on a letter of credit and is now holding the proceeds of that letter of credit, the surety may not be able to hold all of the funds indefinitely and use the Independence Principle as a shield. Despite the fact that the vast majority of courts uphold the view that letters of credit and the proceeds from letters of credit are not property of the estate, several courts have held that excess letter of credit proceeds, namely any proceeds held by the beneficiary of the letter of credit in excess of what is owed under the terms of the underlying agreement between the principal and the beneficiary are property of the estate.[99]

In *Two Trees v. Builders Transport, Inc. (In re Builders Transport, Inc.),* 471 F.3d 1178 (11th Cir.2006), the Eleventh Circuit Court of Appeals decided that the doctrine of independence does not apply once the proceeds of a letter of credit are paid to the beneficiary and, therefore, permitted the debtor to bring a turnover proceeding to recover excess letter of credit proceeds. The Court stated:

> Once the proceeds of a letter of credit have been drawn down, the underlying contracts become pertinent in determining which parties have a right to those proceeds. In other words, an irrevocable standby letter of credit *does not nullify the obligations set forth in the underlying contracts* .... Rather the letter of credit serves, among other things, to shift the burden of litigation ... [The] beneficiary of the letter of credit holds the stake during the litigation.

In re Builders Transport, 471 F.3d at 1186. The *Builders Transport* Court considered which party had the right to the letter of credit proceeds by examining the relevant contract under the applicable state law. The Court decided that the letter of credit beneficiary had a duty to return to the debtor any excess proceeds drawn down from the letter of credit that were not used to secure the debtor's obligations.[100] The Court noted, "[t]he doctrine of independence protects only the *distribution* of the proceeds of the letter of credit."[101]

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[98] *Id.* at 615 (clarification added).

[99] *See Phar–Mor, Inc. v. Fla. Self–Insurers Guar. Assoc., Inc. (In re Phar–Mor, Inc.),* 344 B.R. 852, 856 (Bankr. N.D.Ohio 2005); *In re Lancaster Steel Co.,* 284 B.R. 152 (Bankr. S.D.Fla. 2002); *In re Onecast Media, Inc.,* 439 F.3d 558 (9th Cir. 2006); *Two Trees v. Builders Transp., Inc. (In re Builders Transport, Inc.),* 471 F.3d 1178 (11th Cir.2006).

[100] *Builders Transport,* 471 F.3d at 1187.

[101] *Id. citing In re Graham Square,* 126 F.3d 823, 827 (6th Cir.1997).

Similarly, in *In re Onecast Media, Inc.,* 439 F.3d 558 (9th Cir. 2006), the Ninth Circuit addressed a dispute between a landlord and the trustee of the bankrupt tenant over the excess proceeds of a letter of credit which the landlord had drawn down and held as a security deposit. The *Onecast Media* Court held that the trustee's interest in those funds is property of the estate.[102] Citing to other decisions, the Court noted "[i]t is one thing to attempt to prevent the distribution of the proceeds of a letter of credit, an attempt the doctrine of independence is designed to prevent; but it is quite another to bring an action on the underlying contract that created the letter of credit."[103] The Court further noted, "[t]he fact that Debtor seeks the return of funds that are proceeds of a letter of credit does not negate the breach of contract claim on the underlying obligation."[104]

8. Property Pledged by the Principal as Collateral to Secure the Issuing Bank for Issuance of the Letter of Credit

While letters of credit and the proceeds thereof are generally not considered to be property of the estate, the property that is pledged by the principal to the issuing bank as collateral to secure the issuance of the letter of credit has been held to be property of the debtor's estate.[105] Several courts, including the Fifth, Ninth and Eleventh Circuits, have held that the collateral posted to secure a letter of credit is property of the debtor's estate.[106] The Third Circuit has stated that "where the claim centers around the *collateral* pledged to the bank and *not* the distribution of the proceeds themselves, 'the fact that letters of credit themselves are not property of the estate is a red herring.'"[107] Similarly, in *Matter of Compton,* the Fifth Circuit held expressly: "[o]verall, the letter of credit itself and the payments thereunder may not be property of [the] debtor, but the collateral pledged as a security interest for the letter of credit is."[108]

B. The Principal's Property as the Surety's Collateral in Bankruptcy.

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102 *Int'l Fin. Corp. v. Kaiser Group Int'l Inc. (In re Kaiser Group Int'l Inc.),* 399 F.3d 558, 566 (3d Cir.2005); *In re Graham Square,* 126 F.3d at 828.

103 *Id.*

104 *Id. citing In re Papio Keno Club, Inc.,* 247 B.R. 453, 460 (B.A.P. 8th Cir.2000).

105 *Kaiser Group,* 399 F.3d 566; *OHC Liquidation Trust v. Discover Re (In re Oakwood Homes Corp.),* 342 B.R. 59, 67; (Bankr. D.Del. 2006)*In re S-Tran Holdings, Inc.* 414 B.R. 28, 32-33 (Bankr. D.Del. 2009).

106 *In re Compton,* 831 F.2d at 590-91; *In re Mayan Networks Corp.,* 306 B.R. 295, 299 (9th Cir.BAP 2004); *In re Air Conditioning, Inc.,* 845 F.2d 293, 296 (11th Cir.1988); *In re Metro Comms., Inc.,* 115 B.R. 849, 854 (W.D.Pa.1990).

107 *In re Kaiser Group,* 399 F.3d at 566, *quoting In re Mayan Networks,* 306 B.R. 295, 299 (9th Cir. BAP 2004); *In re S-Tran Holdings, Inc.*, 414 B.R. at 33-34.

108 *In re Compton,* 831 F.2d at 590-91.

As stated previously, in the event the surety has received the principal's real or personal property as collateral for the execution of the commercial surety bonds, including cash, certificates of deposits and deposit accounts, whether contemporaneously with the execution of the commercial surety bonds or pursuant to a "place in funds" demand under the indemnity agreement, once the principal files for bankruptcy protection the automatic stay prevents the surety from exercising its rights against the collateral (the principal's real or personal property) in order to either pay any claims or reimburse the surety for any payments that it may make to commercial surety bond claimants.[109]

Assuming that the surety has a valid, perfected and non-avoidable *under the Bankruptcy Code) security interest in the collateral from the principal which is property of the debtor's estate, the surety will eventually be able to use that collateral to reimburse its loss. This eventuality will occur: (a) when the surety obtains relief from the automatic stay pursuant to section 362(d) of the Bankruptcy Code; (b) the principal, as debtor, consents to the surety's use of the collateral to pay any claims or reimburse the surety for any losses in a separate order; or (c) the principal's chapter 11 plan of reorganization in some way authorizes the surety to exercise its rights against the surety's collateral that is property of the principal's bankruptcy estate (or the principal itself under its plan of reorganization satisfies the commercial surety bond obligations and therefore the surety's liquidation of the surety's collateral is unnecessary in order for the surety to avoid loss under the commercial surety bonds).

C. The Surety's Use of the Surety's Collateral.

The surety does not need relief from the automatic stay to exercise its rights against a letter of credit or the proceeds of a letter of credit. Assuming that the surety has secured the ability to exercise its rights against the surety's collateral that is property of the principal's bankruptcy estate, the next question for the surety is how it may use the surety's collateral to protect the surety from loss.

A surety only needs to use the surety's collateral in the event that the surety either anticipates a loss and expects to make a payment or the surety incurs a loss under the commercial surety bonds. Whether the surety has obtained the proceeds from a letter of credit or is able to liquidate the surety's collateral that is property of the principal's bankruptcy estate and received the net funds from the liquidation, the surety will either want to use the proceeds or the funds to pay any loss prior to the surety's use of its own funds to pay the loss (exoneration) or use the proceeds or the funds to reimburse the surety for any losses that it pays or incurs. Those losses include any commercial surety bond claims that the surety must pay, and any costs and expenses that the surety incurs, including attorneys' fees, accounting fees, investigative fees and expenses, etc. in the handling of the commercial surety bond claims. The surety may also seek payment and/or reimbursement for premiums, interest and the surety's attorneys' fees and expenses in taking action in the principal's bankruptcy case.

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[109] *See* note 17, *supra.*

1. The Surety's Rights Under the Indemnity Agreement.

Pursuant to the surety's indemnity agreement, the surety should have indemnity and reimbursement rights for various losses that the surety has paid in providing commercial surety bonds to the principal, including any losses paid and incurred by the surety, any costs and expenses, including attorneys' fees, consulting fees, investigative fees, etc., and possibly interest on any of the surety's payments.[110] However, while the indemnity agreement will provide that the principal will pay premiums for the commercial surety bonds, there is rarely a provision in the indemnity agreement that both compels the payment and deems the principal's failure to pay the premiums as a loss for which the surety may seek reimbursement.

2. The Surety's Rights Under the Collateral Agreement.

Because the surety's collateral agreement focuses on the collateral the principal provided to the surety, a collateral agreement usually is more detailed with respect to the surety's rights to use the surety's collateral. Most collateral agreements mimic the indemnity agreement with respect to the payment or reimbursement of the surety's losses, costs and expenses, but many collateral agreements also provide that the surety's collateral may be used to pay the surety's premiums for the commercial surety bonds, interest and any other costs and expenses. Furthermore, most collateral agreements provide that the surety may use the surety's collateral until the collateral is either exhausted or the surety is satisfied that it has no further liability under (and/or the surety has been released and discharged from) all of the commercial surety bonds.

C. What Happens If the Agreement is Silent?

If there is no indemnity agreement provision and no collateral agreement regarding how the surety may use the collateral, the surety has several options. First, the surety may negotiate with the principal and attempt to reach an understanding or agreement as to how the collateral will be used. Second, the surety may petition the bankruptcy court and seek an order authorizing the use of the collateral in the manner proposed by the surety. Third, the surety may simply make such use of the collateral as it deems appropriate under the typical broad general rights provided in the indemnity agreement and/or the surety's common law rights. The latter option is not recommended if there is any doubt as to the surety's right to use the collateral in the manner the surety proposes.

V. Obligee and Third Party Claims Against the Commercial Surety Bonds as They Affect the Surety's Use of the Collateral.

There are an enormous number of types and kinds of commercial surety bonds and each has one or more possible claimants. If a surety makes no payments and incurs

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110 *See generally* SURETY INDEMNITY AGREEMENT at pp. 179-223.

no losses under the commercial surety bonds, it does not need to exercise its rights against the surety's collateral. However, because of the automatic stay and the principal's legal (and possible practical) inability to pay its pre-petition obligations during its chapter 11 bankruptcy case, the surety is frequently faced with claims from various claimants against the commercial surety bonds. This section of the paper will discuss the nature and types of claims that may be made against commercial surety bonds, the surety's mechanics and procedures for handling claims against the commercial surety bonds, and the possible attempts that may be made by the principal to set a commercial surety bond claim bar date (the "Surety Claims Bar Date") for claims against the commercial surety bonds in order to obtain the surety's release and discharge from the commercial surety bonds and, therefore, the release and return of the surety's collateral to the principal for the benefit of the bankruptcy estate.

A. The Nature of the Claimants and the Types of Bonds.

Because of the large number of different kinds and types of commercial surety bonds, the identity and nature of the claimants who may make claims against the commercial surety bonds vary greatly. For some commercial surety bonds, for example, utility bonds, there is a named private single party obligee under the bond (the utility). For these commercial surety bonds, the sole claimant would be the obligee under the commercial surety bond. The surety's liability under such a commercial surety bond would be released and discharged in the event it pays a penal sum loss under the commercial surety bond and obtains a full release from the obligee, or the obligee otherwise releases and discharges the surety from its obligations under the commercial surety bond because it has been paid any and all claims that the obligee may have. The obligee may also agree that it has no claims and voluntarily releases and discharges the commercial surety bond. Once the commercial surety bond is released and discharged, the surety has no further obligations under the commercial surety bond. If it has incurred a loss, the surety will seek reimbursement from the surety's collateral to the extent of its loss. To the extent the surety receives a release and discharge on the commercial surety bond and pays the loss, the remaining amount of the surety's collateral will be available to reimburse the surety for losses on other commercial surety bonds.

Many commercial surety bonds have a statutory obligee (various state or local governments). Such commercial surety bonds include license bonds, tax bonds, permit bonds, etc. To the extent that the statutory bonds have only one obligee, and no other people or entities may claim under the statutory bond, the surety's obligations to "claimants" under such commercial surety bonds are similar to the private single party obligees under those bonds (such as utility bonds).

However, many statutory commercial surety bonds name as the obligee the state or local government, but also provide rights to third party claimants who may make claims against the statutory commercial surety bonds either through the government obligee or independent of the government obligee. These commercial surety bonds include contractor license bonds, mortgage broker bonds, warranty bonds, games of chance bonds and other business related commercial surety bonds that allow third party

claimants other than the governmental obligee to make a claim. It is virtually impossible for a surety to receive a release and discharge of such a commercial surety bond where the obligee and third party claimants may have claims unless the surety has paid out the full penal sum of the commercial surety bond and received a release and discharge as a result. Otherwise, the surety has no knowledge of what other claimants may exist and how to identify those potential claimants.

B. The Surety's Claims Handling.

Frequently, a surety receives numerous claims fairly quickly after the principal files its bankruptcy case. Because the automatic stay prevents the principal's creditors from collecting their pre-petition debts from the principal, those claimants will look to the commercial surety bonds to pay their pre-petition obligations. Occasionally, as the principal's bankruptcy case proceeds, claimants may make claims against the commercial surety bonds for the principal's obligations incurred post-petition, after the date of the filing of the bankruptcy case. While such post-petition obligations are treated differently from pre-petition obligations, mainly because post-petition obligations are administrative expenses of the principal in its bankruptcy case, the commercial surety bonds may still be exposed to pay both pre-petition and post-petition obligations. The following is a brief discussion of the surety's claims handling mechanics and procedures when it receives claims against the commercial surety bonds after the principal files its bankruptcy case.

1. Investigation, including Notice to the Principal and the Principal's Input on the Claim.

Each time that the surety receives a claim against a commercial surety bond, it should notify the principal and the principal's counsel and obtain the principal's input on the claim. Frequently, the principal in a large commercial surety bankruptcy case has good records concerning what it owes and what it may dispute, and many of the claims against the commercial surety bonds may be invalid claims. If the principal disputes the claim, the surety may obtain additional information from the claimant and the principal in an attempt to determine whether or not the claim is a valid claim against the commercial surety bond which should be paid or not paid.

2. The Surety's Right to Settle the Claim.

Under most indemnity agreements, a surety has the right to settle claims against the commercial surety bond.[111] The question of whether the surety can settle a claim against a commercial surety bond without violating the automatic stay has not been definitively addressed by the bankruptcy courts.[112] In the absence of clear authority

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[111] *See* SURETY INDEMNITY AGREEMENT pp. 333-359; *see* THE SURETY AND BANKRUPTCY 90-93 (J. Blake Wilcox, Steven H. Rittmaster, Alberta "Ali" L. Adams and Patricia Wager, eds 2010), hereinafter referred to as "SURETY AND BANKRUPTCY."

[112] *See, e.g., In re Levitz Elec., Inc.,* 100 B.R. 602 (Bankr. S.D.Fla. 1989). The authors have not found any cases directly addressing the issue.

supporting the surety's indemnity agreement rights to make such settlements and in light of the potential penalties the surety may face for violating the automatic stay, the best course of action is to negotiate a settlement of claims order with the principal which includes a lifting of the stay and agreed upon terms for handling and settling claims. Such an order can be put in place early and cover all future claims.

3. The Effect on the Surety's Right to Use the Collateral Upon Settlement of the Claim.

While the surety may not violate the automatic stay by exercising its indemnity agreement rights to settle a claim against a commercial surety bond, if the principal has objected to the surety's settlement of the claim, that objection may have an effect on the surety's rights to use its collateral to either pay the settlement of the claim or to reimburse the surety for its payment of the settlement of the claim. If the surety uses the proceeds from the letter of credit to settle the claim despite the principal's disputes, the surety would argue that it has the right to use the letter of credit proceeds because they are not property of the principal's bankruptcy case, and, therefore, it is not costing the principal anything. If the surety attempts to use the surety's collateral that is property of the principal's bankruptcy case, assuming that it has the right to use such collateral (the surety has obtained relief from the automatic stay), the principal may have greater rights to object to the surety's actions and the surety's ability to either exonerate the surety or obtain reimbursement of the surety for its payment of the settlement of the claim.

C. The Principal's Attempts to Set a Surety Claims Bar Date Against the Commercial Surety's Bonds to Obtain a Return of the Collateral.

Obviously, if the surety is retaining rights and holding onto the surety's collateral that is property of the principal's bankruptcy case, the principal eventually wants the collateral back in order to either use it to partially fund its plan of reorganization and/or to pay other debts and expenses. The principal will contend that the surety is either fully collateralized for any potential loss under its commercial surety bonds or that the risk of exposure to loss for the surety is minimal because of the nature of the risk and/or the passage of time.

The surety's risk of exposure under commercial surety bonds can be eliminated after the surety has paid out the penal sum of the commercial surety bond in full and received a release and discharge of the commercial surety bond, or the surety has made a partial payment or no payment under the commercial surety bond and still has received a voluntary release and discharge from the obligee.[113] This will not occur when there are third party claimants, in addition to the obligee, who may have a claim against the commercial surety bond.

More importantly, the surety's obligations under commercial surety bonds do not expire until passage of the applicable statute of limitations for the commercial surety

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[113] *See generally* SURETY INDEMNITY AGREEMENT at pp. 155-56.

bonds regardless of who the claimants may be. The statute of limitations issue exists whether or not the surety has been able to successfully cancel the commercial surety bonds either prior to or after the date of the principal's bankruptcy case.[114]

Because the surety's liabilities under the commercial surety bonds may extend out for many years, a principal in its bankruptcy case may attempt to set a Surety Claims Bar Date against all possible claimants under the commercial surety bonds in order to cut off the claimants' rights and initiate and/or require the surety's release and return to the principal of the surety's collateral.

While the concept of setting a Surety Claims Bar Date sounds enticing for both the surety (to eliminate possible future claims) and the principal (to get its collateral back into the debtor's estate), the reality is that the bankruptcy court may not have the authority to issue such relief. If a Surety Claims Bar Date is set and the collateral is returned after the Surety Claims Bar Date, the surety may still be exposed to claimants who will argue that they are not bound by the Surety Claims Bar Date after the surety surrenders the collateral. In the context of setting a Surety Claims Bar Date, it must be recognized that the surety is a third party to the bankruptcy case and the potential claimants under the commercial surety bonds are also third parties to the bankruptcy case. Bankruptcy courts have only limited authority to address the claims of one third party (bond claimants) against another third party (the surety). There is no provision in the Bankruptcy Code that gives the bankruptcy court express authority to enter an order that releases the surety's liability, as a third party, to other third party claimants under commercial surety bonds.

The only Bankruptcy Code section cited by debtors to establish a Surety Claims Bar Date is 11 U.S.C. § 105.

Section 105 (a) of the Bankruptcy Code provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105 (a).

While § 105 (a) appears to provide broad power to the bankruptcy courts, it is intended merely to supplement a bankruptcy court's enumerated powers and many courts

[114] The surety's cancellation of the commercial surety bonds is discussed briefly in section VI.A.2. in this paper, *infra*.

have observed that its reach is not unlimited. The Third Circuit in *United States v. Pepperman*, 976 F.2d 123, 131 (3rd Cir. 1992), stated that § 105(a) does not "create substantive rights that would otherwise be unavailable under the Bankruptcy Code."[115] Similarly, the Ninth Circuit has recognized that "[b]ankruptcy judges have no more power than any others to ignore the plain language of a statute in order to reach a result more in keeping with their notions of equity."[116]

Moreover, § 524 of the Bankruptcy Code specifically provides that the bankruptcy discharge of a debtor under a confirmed plan of reorganization does not relieve non-debtor third parties of their liabilities.[117] Thus, the discharge of the principal would ordinarily not relieve the surety of its liabilities to commercial surety bond claimants. Numerous courts, including the Fifth, Ninth and Tenth Circuits, have concluded that section 524(e) precludes them from authorizing releases of and/or injunctions against the claims of third parties against non-debtors, finding these to be the equivalent of a non-debtor discharge.[118]

In certain limited circumstances, some courts have allowed the bankruptcy process to affect the rights and liabilities between third parties. For example, the Fourth Circuit exercised authority over non-debtor liability in the context of a chapter 11 reorganization plan approval in *Menard-Sanford v. Mabey (In re A.H. Robins Co.),* 880 F.2d 694, 701-02 (4th Cir. 1989), *cert. denied*, 493 U.S. 959 (1989). In *A.H. Robins*, the maker of the Dalkon shield was forced into bankruptcy by over-whelming liability exposure arising from product liability litigation. In that context, the Fourth Circuit approved a reorganization plan that provided releases of third party claims against other third parties to the bankruptcy such as the debtor's directors, insurers and their attorneys (some of whom had indemnity rights against the debtor). The Fourth Circuit held that such assertion of authority was necessary for a successful reorganization. However, it should also be noted that the Court required that consideration be given to the third party claimants for the releases, including consideration given by some of the parties receiving releases.[119] Thus, in exchange for the debtor's insurers creating a pool of funds to be

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[115] *Id. quoting In re Morristown & Erie R.R.Co.*, 885 F.2d 98, 100 (3d Cir. 1989); *see also Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) (noting that the bankruptcy court's equitable powers can only be exercised within the confines of the Bankruptcy Code).

[116] *In re Kelly*, 841 F.2d 908, 913 n.4 (9th Cir. 1988).

[117] Section 524(e) provides: **"**Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

[118] *See, e.g.*, *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995); *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995), *cert. denied*. 517 U.S. 1243 (1996); *Landsing Diversified Props. – II v. First Nat'l Bank & Trust Co. of Tulsa (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 601 (10th Cir. 1990), *modified by Abel V. West*, 932 F.2d 898 (10th Cir. 1991); *In re Future Energy Corp.*, 83 B.R. 470, 486 (Bankr. S. D. Ohio 1988)("The clear weight of decisional authority supports the proposition that Chapter 11 plans which call for the release of nonparties (such as guarantors) from liability upon obligations of the debtor are violative of § 524(e)").

[119] *See also Securities and Exchange Commission v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 960 F.2d 285, 293 (2nd Cir. 1992); *MacArthur Co. v. Johns-*

distributed to the third party claimants, the Court released the insurers from any further liability. With respect to *A.H. Robins* and other such cases, the Third Circuit observed, while rejecting an attempt to provide third party releases in a chapter 11 proposed plan:

> A central focus of these three reorganizations was the global settlement of massive liabilities against the debtors and co-liable parties. Substantial debtor co-liable parties provided compensation to claimants in exchange for the release of their liabilities and made these reorganizations feasible.

In re Continental Airlines, 203 F.3d 203, 212-213 (3rd Cir. 2000).

Aside from the mass tort context, there is no legal authority to support the extraordinary relief of barring third party claims against a third party. In the case of *In re Berwick Black Cattle Co.*, 394 B.R. 448 (Bankr. C.D. Ill. 2008), the bankruptcy court addressed a blanket third-party release provision in a proposed chapter 11 liquidating plan. In denying confirmation, the bankruptcy court held that the proposed release provisions prevented the court from approving the plan. In rejecting the plan, the court stated:

> [P]rudence demands that third-party releases be viewed with a healthy dose of skepticism. This Court is aware of no authority, outside of the mass tort context, that supports the granting in the plan of a nonconsensual third-party release of claims other than for acts or omissions made in the bankruptcy proceeding, with gross negligence and willful misconduct excluded.

Id. at 460.

The surety must be cognizant of the limits of the bankruptcy court's authority when the surety's collateral is at stake because if the bankruptcy court acts beyond the scope of its authority, a future claimant may be able to raise that as a defense and preserve its claim against the surety.

In summary, any surety would like the bankruptcy court to establish an *effective* Surety Claims Bar Date that would cut off the surety's responsibilities and obligations under the commercial surety bonds as of a certain date. For example, if a surety had $1 million worth of collateral and $1 million worth of remaining commercial surety bond exposure, the failure of any commercial surety bond claimant to file a claim against the commercial surety bond as of the Surety Claims Bar Date would release the surety from any exposure for that commercial surety bond. The ultimate result would be that the

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Manville Corp. (In re Johns-Manville Corp.), 837 F.2d 89, 94 (2nd Cir. 1988), *cert. denied*, 488 U.S. 868 (1988).

surety would have no remaining exposure under the $1 million worth of commercial surety bonds, thereby allowing the surety to release and return to the principal's bankruptcy estate $1 million worth of the surety's collateral (less any payments the surety may keep pursuant to its indemnity agreement and/or common law rights). However, if such a Surety Claims Bar Date is later held to be ineffective, because the bankruptcy court exceeded its authority to issue such a Surety Claims Bar Date, the surety would not want to release the surety's collateral with the prospect that a future valid claim may be made against one of the commercial surety bonds for which the surety is liable, and yet the surety no longer has the surety's collateral to either pay the claim or reimburse the surety for its loss.

VI. Maintaining and Preserving the Surety's Collateral for Future Claims.

The next issue to address is how does a surety maintain and preserve the surety's collateral for future claims that may arise against the commercial surety bonds. Initially, while the surety may have paid certain claims of obligees and third party claimants under the commercial surety bonds, the surety may still retain some of the remaining surety collateral. Whether or not some or all of the commercial surety bonds have been validly cancelled, and assuming that no Surety Claims Bar Date has been established (either because the principal has not attempted to set such a Surety Claims Bar Date or the principal's attempt has been denied by the bankruptcy court), the surety will continue to have contingent liabilities to the obligees and any third party claimants under the remaining commercial surety bonds. The surety wants to maintain and preserve the surety's collateral for the payment of such future contingent liabilities and claims, and hold onto the surety's collateral until the surety is completely released and discharged from all of its possible commercial surety bond obligations.

As much as the surety wishes to maintain and preserve the surety's collateral, the principal, or its succeeding trustee, will want the remaining portion of the unused surety collateral returned to the principal's bankruptcy estate in order to distribute those funds to various creditors, including administrative expense claims, priority claims and unsecured claims. Essentially, the principal and/or the trustee will see a "pot of money" represented by the surety's collateral that the surety is holding due to the potential but contingent claims remaining under the commercial surety bonds.

A. Avoiding Future Claims and/or Preserving the Surety's Claims Against the Surety's Collateral.

While beyond the scope of this paper, the following is a list of the issues that the surety may face as it attempts to either avoid future claims and/or maintain and preserve the surety's right to the collateral.

1. The Surety's Proof of Claim.

The surety should file a proof of claim in the principal's bankruptcy case.[120] The surety's proof of claim will assert a secured claim for the surety's collateral that is property of the principal's bankruptcy estate. In the event that the principal's "security" serving as the surety's collateral is a letter of credit or its proceeds, the surety's proof of claim will assert the surety's rights in the letter of credit and the proceeds while stating that the letter of credit and the proceeds are not property of the principal's bankruptcy estate.

To the extent that the surety's proof of claim is contingent because it is based upon the amount of the unpaid penal sums of the commercial surety bonds and there are potential future claims, presently contingent, against the commercial surety bonds, the principal may attempt to disallow the surety's secured claim based upon the contingent nature of all or a portion of the surety's secured claim. The principal may object to the surety's proof of claim and seek disallowance of the claim pursuant to Section 502(e) of the Bankruptcy Code.[121] The surety's right to retain the surety's collateral even if the surety's claim is disallowed under section 502(e) of the Bankruptcy Code is discussed in this paper in Section VI.B., *infra.*

2. The Surety's Cancellation of the Commercial Surety Bonds.

Assuming that the surety has taken the appropriate steps, including seeking relief from the automatic stay,[122] the surety may cancel those commercial surety bonds that may be cancelled.[123] While the surety's cancellation of any commercial surety bonds will cut off the surety's exposure for any claims that may arise <u>after</u> the commercial surety bonds' respective cancellation effective dates, the surety will remain contingently liable for up to the amounts of the penal sums of the commercial surety bonds until the applicable statute of limitations for each of the commercial surety bonds has expired.

Care must be taken in the process of cancelling the commercial surety bonds as the requirements of cancellation must be followed precisely to avoid a later claim that the

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[120] There have been a number of publications concerning the surety's proof of claim. These include: George J. Bachrach and Frank M. Lanak, *The Surety's Proof of Claim: Obtaining Reimbursement for the Loss* (unpublished paper submitted at the Nineteenth Annual Northeast Surety and Fidelity Claims Conference on September 18, 2008); SURETY AND BANKRUPTCY, CHAPTER 7 AT PP. 139-70; and SURETY INDEMNITY AGREEMENT at pp. 477-83.

[121] Section 502(e)(1) of the Bankruptcy Code provides that the "court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor to the extent that – (B) such claim for reimbursement or contribution is contingent as of the time of the allowance of disallowance of such claim for reimbursement or contribution."

[122] Cancelling a commercial surety bond without bankruptcy court approval for relief from the section 362 automatic stay has been held to be a violation of the automatic stay. *See, In re Wegner Farms Co.*, 49 B.R. 440, 442 (Bankr. Iowa 1985); *In re Advent Corp.,* 24 B.R. 612, 614 (B.A.P. App. 1st Cir. 1982) (the cancellation is ineffective); *In re R.O.A.M., Inc.,* 15 B.R. 616, 617 (Bankr. Nev. 1981).

[123] SURETY AND BANKRUPTCY, Chapter 6 at pp. 123-138.

commercial surety bond was not cancelled properly and is therefore still open. Cancellation provisions may exist in the terms of the commercial surety bond itself or may be contained in the terms of an applicable statute or regulation, or both. Further, there may be conflicting terms between the two. Moreover, persons or locations identified for providing notice may no longer be in existence due to the passage of time or the business circumstances of the obligee. The surety must also check for any riders or amendments to the commercial surety bonds to see if any changes were made to the cancellation provisions. Finally, the specific manner of cancelling the commercial surety bonds must be followed, such as sending the notice by certified or registered mail, sending copies to certain persons, and other similar provisions regarding the logistics of the cancellation.

As part of the cancellation process, the surety should consider sending all cancellation notices out by certified mail, return receipt requested so that the surety can track and have a record of the dates of receipt of the notices. While there may be some cost to this approach, documenting the obligees' receipt of the notice may be critical to obtaining an effective cancellation. Moreover, the surety may want to include an acknowledgment form with the cancellation notice for each commercial surety bond which would request the relevant obligee to acknowledge that it has no pre-cancellation claims against the commercial surety bond.

3. The Surety Claim Bar Date.

If a Surety Claims Bar Date is tied together with a subsequent request for the release of collateral, the surety should have real concern with a principal's attempts to establish such a Surety Claims Bar Date in bankruptcy. On the other hand, the establishment of a Surety Claims Bar Date can be helpful to the surety as long as it is not tied to a release of collateral. In cases where the potential bond claimants are known and have received notice of the Surety Claims Bar Date, and such claimants have also asserted claims in the bankruptcy against the principal, it can be effectively argued that such claimants are indeed subject to and bound by the Surety Claims Bar Date and the surety may seek to use the Surety Claims Bar Date as a defense against claims from such claimants. If there is no release of collateral and the Surety Claims Bar Date is ultimately deemed to be ineffective for some reason, the surety is still protected by its collateral.

It may be that the surety will want to seek a middle ground where a Surety Claims Bar Date is issued and the surety agrees to release some of its collateral in exchange for an agreement with the principal/debtor that the surety can retain the remainder of its collateral for an extended period of time until all potential liability is extinguished. Under this approach, the surety may need to engage consultants and experts to evaluate the potential future liability on the commercial surety bonds issued so that the surety can determine what amount of collateral it must retain. There may be other arrangements that can be made with the principal as it emerges from bankruptcy in the form of new collateral that could also protect the surety from future claims, such as issuance of preferred stock or bonds to the surety in the reorganized principal.

4. Preferences.

Any time that a surety receives collateral from a principal, and the principal then files a bankruptcy case within 90 days (the preference period), the surety may face the principal's attempt to avoid the principal's transfer of the collateral to the surety as a preference under section 547 of the Bankruptcy Code.[124] To the extent that the surety receives collateral that is part of the property of the estate within the preference period and the surety does not have any of the statutory defenses, the surety may lose its collateral in a preference action. What makes the loss of the collateral even more disturbing is the fact that the loss of the collateral may not occur until over two years after the bankruptcy case was filed. Pursuant to the Bankruptcy Code, the principal, as debtor in possession, and/or a trustee have up to two years from the "entry of the order for relief," which is generally the date of filing the bankruptcy petition, to initiate preference actions.[125]

As discussed above, with respect to collateral in the form of letters of credit, because of the independence principle and the fact that letters of credit are not considered to be property of the estate, many courts hold that the preference avoidance powers do not apply to letters of credit or proceeds therefrom.[126] However, under certain circumstances, even though a letter of credit and the proceeds of a letter of credit are not property of the principal's bankruptcy estate, courts have held that the surety's receipt of a letter of credit may constitute a preferential payment to the surety.[127]

In *In the Matter of Compton Corp.,* 831 F.2d 586 (5th Cir. 1987), the Court held that the issuance of the letter of credit constituted an indirect preference which could be avoided under § 547 of the Bankruptcy Code. In *Compton*, a supplier delivered a shipment of oil to a buyer. The buyer was unable to pay for the oil, but it was able to get its bank to issue an irrevocable standby letter of credit in favor of the supplier. Under the terms of the letter of credit, the issuing bank was obligated to pay up to the full amount owed for the shipment of oil if the buyer failed to pay by a certain date. To obtain the letter of credit, the buyer paid the issuing bank a small fee and gave a promissory note payable on demand for the full amount of the letter of credit. The issuing bank was also covered by a prior perfected security agreement with the buyer which included the issuance of the letter of credit under the "future advances" clause. The letter of credit on its face noted that it was for an *antecedent debt* due to the supplier. The day after the letter of credit was issued, several of the buyer's creditors filed an involuntary bankruptcy petition against the buyer. The buyer failed to make payment to the supplier for the oil and the issuing bank paid the full amount of the letter of credit to the supplier.

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124 SURETY AND BANKRUPTCY, Chapter 10 at pp. 215-30.

125 11 U.S.C. § 546 (a).

126 *See* Section IV (A)(5).

127 *Air Conditioning, Inc. of Stuart,* 845 F.2d 293 (11th Cir. 1988), *citing In re Compton,* 831 F.2d 586, 594-95 (5th Cir. 1987).

In the ensuing bankruptcy, the issuing bank was ultimately paid in full for its secured losses, including the payment made under the letter of credit, from the proceeds of the liquidation of the buyer. The trustee filed a complaint against the *supplier* seeking to avoid the payment under the letter of credit to the supplier as a preference. The trustee claimed that the direct transfer to the issuing bank of the increased security interest also constituted an indirect transfer to the supplier, which occurred one day prior to the filing of the involuntary bankruptcy petition and was therefore voidable as a preference under 11 U.S.C. § 547.

The *Compton* Court acknowledged that letters of credit are not property of the estate and that the payment under the letter of credit was made from the assets of the issuing bank.[128] However, the Court observed that it was "important" to note that the irrevocable standby letter of credit in the case was not arranged in connection with the supplier's initial decision to sell the oil to the buyer on credit.[129] Rather, the buyer arranged for the letter of credit after the supplier had shipped the oil and after the buyer had defaulted in payment. The *Compton* Court stated:

> The letter of credit in this case did not serve its usual function of backing up a contemporaneous credit decision, but instead served as a back up payment guarantee on an extension of credit already in jeopardy. The letter of credit was issued to pay off an antecedent unsecured debt. This fact was clearly noted on the face of the letter of credit. [The supplier], the beneficiary of the letter of credit, did not give new value for the issuance of the letter of credit by [the issuing bank] . . . , or for the resulting increased security interest held by the [issuing bank].

In the Matter of Compton, 831 F.2d at 590 (clarification added).

Under the Court's analysis, when a debtor pledges its assets to secure a letter of credit, a transfer of debtor's property has occurred under the provisions of 11 U.S.C. § 547.[130] Specifically, by the debtor subjecting its assets to the issuing bank's reimbursement claim in the event the letter of credit is paid, the debtor makes a transfer of its property. The Court noted that the broad definition of "transfer" under 11 U.S.C. § 101(50) is clearly designed to cover such action. Thus, the Court stated, "[o]verall, the letter of credit itself and the payments thereunder may not be property of debtor, but the collateral pledged as a security interest for the letter of credit is."[131]

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[128] *In re Compton,* 831 F.2d at 589.

[129] *Id.* at 590.

[130] *Id.*

[131] *Id.* at 590-91.

Essentially, the *Compton* Court believed that an unsecured creditor was being "substituted" for a secured creditor to the detriment of the estate. If there had been no letter of credit, the buyer would have defaulted on the payment for the oil shipment and the supplier would have been an unsecured creditor in the bankruptcy. But, because of the letter of credit arrangement, the buyer entered into a secured transaction with the issuing bank in the amount of the letter of credit, the supplier was paid in full by the issuing bank, and the supplier's obligation was in effect transferred to the issuing bank as a secured claim. Thus, both the issuing bank and the supplier were paid in full and the unsecured creditors of the bankrupt estate received less. If the buyer had attempted to make a payment to the supplier directly for the antecedent debt, it would have been a preference. Therefore, the Compton Court held that "[t]o constitute a preference, it is not necessary that the transfer be made directly to the creditor. . . . If the bankrupt has made a transfer of his property, the *effect* of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it."[132]

The *Compton* case turned on the specific facts of the case where the letter of credit was issued after the fact for an antecedent debt. The *Compton* Court acknowledged that had the letter of credit been issued as part of the original transaction there would not have been a preference because the letter of credit would have been part of the new value consideration. The Court stated:

> In the letter of credit cases . . . the letters of credit were issued contemporaneously with the initial extension of credit by the beneficiaries of the letters. In those cases the letters of credit effectively served as security devices for the benefit of the creditor beneficiaries and took the place of formal security interests. The courts in those cases properly found there had been no voidable transfers, direct or indirect, in the letter of credit transactions involved. New value was given contemporaneously with the issuance of the letters of credit in the form of the extensions of credit by the beneficiaries of the letters. As a result, the 11 U.S.C. § 547(c)(1) preference exception was applicable.

Matter of Compton, 831 F.2d at 594.

B. The Surety's Collateral is Protected Under 11 USC Section 506(d) to the Extent of the Surety's Lien if the Surety's Claim is Disallowed as a Claim Under 11 USC Section 502(e).

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[132] *Id.* at 591, *citing Nat'l Bank of Newport v. Nat'l Herkimer County Bank,* 225 U.S. 178, 184, 32 S.Ct. 663, 635, 56 L.Ed. 1042 (1912).

The Bankruptcy Code, 11 U.S.C. § 506 (d), may provide the surety with an argument that the surety is entitled to retain the proceeds from the letter of credit (and any other collateral, even if it is property of the debtor's estate) until the surety is fully released and discharged from all liability under the commercial surety bonds.

Section 506 (d) provides in relevant part:

> To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless –
>
> (1) such claim was disallowed only under section 502(b)(5)[133] or 502(e) of this title; or . . .

11 U.S.C. § 506 (d).

Section 101 (5) of the Bankruptcy Code defines "claim" broadly as "(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured."[134] With respect to the surety's contingent claims, 11 U.S.C. § 502 (e) provides in relevant part:

> (e)(1) Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, <u>the court shall disallow any claim for reimbursement</u> or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that—
>
> > (A) such creditor's claim against the estate is disallowed;
> > (B) <u>such claim for reimbursement</u> or contribution <u>is contingent as of the time of allowance or disallowance of such claim for reimbursement</u> or contribution; or
> > (C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

11 U.S.C. § 502 (e) (emphasis added).

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133 Section 502(b)(5) is not applicable to this discussion.

134 11 U.S.C. § 101 (5).

Notwithstanding any such possible future disallowance which may occur with respect to the surety's contingent claim for reimbursement, the surety retains its rights against the letter of credit proceeds (and any other collateral, even if it is property of the debtor's estate) pursuant to §506 (d). The Bankruptcy Code defines "lien" as a "charge against or interest in property to secure payment of a debt or performance of an obligation."[135]

To the extent that the surety has and maintains control over its letter of credit collateral or maintains possession over the letter of credit proceeds as cash, the surety has a perfected security interest in such collateral. The letter of credit proceeds constitute "money" intended to secure payment of the principal's performance of its obligations under the commercial surety bonds and to reimburse the surety under the terms of the indemnity agreement with the principal. Accordingly, under 11 U.S.C. § 506(d), the surety is entitled to retain possession of the proceeds of the letter of credit until its liability has been fully released, discharged and extinguished under the commercial surety bonds and the surety has been fully reimbursed pursuant to the terms of the indemnity agreement.

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[135] 11 U.S.C. § 101 (37).