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*By David Gray Carlson and William H. Widen**

INTRODUCTION

No legal concept is held more sacrosanct to the letter of credit business than the "independence" principle. This doctrine holds that an issuing bank's obligation to honor draws on a letter of credit is entirely independent of the bank's account party and its underlying contract with the beneficiary.[1] Except in cases of fraud by the beneficiary,[2] the account party cannot countermand the credit,[3] even if the account party has valid defenses against the beneficiary's direct right to payment.[4] Consequently, the

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1. In the typical case, three separate contracts exist. First, the letter of credit represents the obligation of the issuing bank to the beneficiary to honor draws made by the beneficiary in accordance with the terms of the credit. *See* JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT ¶ 3.03[1], at 3-7 to 3-10 (rev. ed. 1999) (emphasizing that "consideration" is not required to uphold the bank's obligation to pay). Second, the issuing bank has a contract with its customer—the account party—pursuant to which the account party agrees to reimburse the issuing bank for draws honored. Third, the beneficiary has an underlying contract with the account party, pursuant to which the account party owes or might owe money to the beneficiary. As party to this third contract, the beneficiary has required that the account party procure a letter of credit so that the beneficiary is not subject to the credit risk of the account party for performance of these obligations. For a description of this tripartite relation, see *P.A. Bergner & Co. v. Bank One (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1114-15 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998); Paul R. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 719-20 (1973). For a good essay on standby letters of credit from the perspective of bank regulation, see Henry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits?*, 1988 COLUM. BUS. L. REV. 705.
2. *See infra* text accompanying notes 370-72.
3. *See, e.g.*, U.C.C. § 5-106(b) (1995). Of course, by agreement a letter of credit may be made revocable.
4. *Id.* § 5-108(f); *see* Amelia H. Boss, *Suretyship and Letters of Credit: Subrogation Revisited*, 34 WM. & MARY L. REV. 1087, 1105 (1993) (identifying the repeal of suretyship defenses as the chief point of the independence principle); John F. Dolan, *A Study of Subrogation Mostly in Letter of Credit and Other Abstract Obligation Transactions*, 64 MO. L. REV. (forthcoming 1999).

bank must pay even if the account party files for bankruptcy.[5] This promise of immunity from the customer's bankruptcy has led to the popularity of the "standby letter of letter of credit," which provides assurance of payment against this bankruptcy risk. Indeed, a letter of credit is often used in a structured finance transaction on the premise that the letter of credit will stand like"a galled rock," though "swilled with the wild and wasteful ocean" of the account party's bankruptcy.[6]

In this Article, we argue that the independence principle has been invoked improperly by courts to find that the issuance of a letter of credit by a bank does not involve a transfer of debtor property by the bank's customer, the account party. A corollary to this improper use of the independence principle—that a letter of credit and its proceeds can never be recovered by an account party's bankruptcy trustee—is also wrong. Courts have analyzed transactions improperly in order to find that *other* transfers (such as security interests) may create voidable preferences.

We conclude that issuance of a letter of credit by a bank does indeed involve a transfer of property of the account party and that, in appropriate circumstances, an account party's bankruptcy trustee may recover a letter of credit or its proceeds from the beneficiaries. Admittedly, our conclusions contradict the current view of judges and commentators.[7] Yet we will show why the current views are unsatisfactory and self-defeating, and why our reconceptualization is the only one that reconciles letters of credit with the logic of federal bankruptcy law. The result, we believe, is a more secure grounding for the letter of credit trade—one that honors the good results (if not reasoning) achieved by existing cases.

Central to this Article is the paradigm of an abusive letter of credit transaction (ALCT). In the paradigm, the bad creditor (TBC) is owed $1000 by debtor (D). This debt has been outstanding for some significant period of time and is unsecured. At a later date, D obtains a secured line of credit with issuing bank (IB). TBC convinces D to cause IB to issue a letter of credit to TBC to support D's previously existing (i.e., antecedent) $1000 debt to TBC. This transaction has the effect of converting TBC's unsecured loan into a secured loan. TBC's $1000 loan is antecedent to the provision made for its security. If the provision for security is made

5. Douglas G. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130, 149-51 (1982). Nevertheless, a few cases have enjoined letters of credit under Bankruptcy Code § 105(a). For denunciations, see Howard N. Gorney, *Enjoining Payment of Letters of Credit Under the Bankruptcy Code: New Concerns for Issuers and Beneficiaries*, 66 AM. BANKR. L.J. 333, 345 (1992) (criticizing as lawless cases in which courts have enjoined letters of credit in the absence of a bankruptcy avoidance theory); Juliet M. Moringiello, *Silencing the Loose Cannon: The Need for the Bankruptcy Code to Recognize Letters of Credit*, 27 LOY. L.A. L. REV. 619 (1994).

6. William Shakespeare, Henry V, Act 3, Scene 1.

7. *See, e.g.*, Michael St. Patrick Baxter, *Letters of Credit and the* Powerine *Preference Trap*, 53 BUS. LAW. 65, 69 (1997) (stating that "[i]ndeed, courts have ruled almost universally that a letter of credit and the proceeds thereof are not property of the debtor's bankruptcy estate").

within ninety days of bankruptcy, this transaction prefers TBC to other unsecured creditors. TBC draws the letter of credit to pay its $1000 loan in full. Now IB is owed a $1000 reimbursement obligation from D, but this obligation is secured (and, thus, has priority over unsecured creditors). IB is protected as a secured creditor to the extent of collateral value. A $1000 unsecured claim has been replaced by a $1000 secured claim. (If the reimbursement obligation owed to IB is unsecured, the transaction is not an ALCT; the replacement of one unsecured $1000 claim with another unsecured $1000 claim is accepted as an instance of earmarking.)[8]

Because courts wrongly believe that they are not free to challenge directly the issuance of the letter of credit itself as a transfer of debtor property, they choose instead to challenge the security interest granted to IB. Courts reason that the grant of the security interest was a transfer *to* IB (albeit protected because of new value provided by IB to D); also the grant of the security interest was a transfer *for the benefit* of TBC. Courts permit recovery of the "benefit" from TBC. Some courts also theorize that TBC was an indirect transferee of the IB's security interest. These courts allow the bankruptcy trustee to recover the value of the indirect transfer from TBC as an alternative theory of preference.

What has escaped notice is that equating the grant of the security interest with the preferential transfer in these ways, rather than directly challenging the issuance of the letter of credit, creates unintended risks for legitimate collateral protection given by debtors to issuing banks. Further, attacking the security interest, and not the issuance of the letter of credit, does not even provide a sound basis for controlling many types of abusive creditor behavior.

Our analysis permits a direct attack against the ALCT but leaves intact traditional, legitimate uses of trade letters of credit.[9] It has no harmful side effects for security interests granted to banks and directly controls preferential transactions.

In addition to our reconceptualization of the ALCT (in which IB takes collateral from D), we also digress, in the name of completeness, into the voidable preference issues that arise when IB is initially unsecured. An unsecured IB gives rise to the possibility of TBC's valid claim of earmarking.[10] It is our intent to reconceptualize this common law defense to

8. See our discussion of earmarking *infra* text accompanying notes 114-32, 255-72.

9. Most letter of credit transactions do not involve voidable preferences. Whether a letter of credit is direct pay or issued on a standby basis does not inform the analysis. The sole question is whether the letter of credit was issued in respect of antecedent debt without the provision of new value to the debtor as in the case of the ALCT. *See infra* text accompanying notes 12-19.

10. Earmarking refers to the substitution of one unsecured creditor for another. *See infra* text accompanying notes 117-18. In such a case, TBC is given a "nonstatutory" defense against voidable preference liability. Our revision of earmarking doctrine is justified at length in David Gray Carlson & William H. Widen, *The Earmarking Defense to Voidable Preference Liability: A Reconceptualization*, 72 AM. BANKR. L.J. (forthcoming 1999). Application of these ideas to letters of credit appears *infra* in the text accompanying notes 114-33.

show that, in actuality, it is nothing other than a special case of the "contemporaneous exchange" defense now codified in Bankruptcy Code section 547(c)(1).[11] If we succeed, the parameters of earmarking change considerably for the better. The new theory of earmarking is one of general application, by no means limited to, but nevertheless quite important for, letter of credit cases.

A second issue arises if IB is unsecured. To what extent can IB take security interests before TBC actually draws? The answer to this question depends on what an "antecedent debt" is. This Article will present a new definition of that important voidable preference concept. Both of these theoretical innovations are provoked by the recent case of *P.A. Bergner & Co. v. Bank One (In re P.A. Bergner & Co.)*,[12] which is sure to be a landmark case on the regulation of IB's through voidable preference law.

This Article begins by explaining why the traditional analysis of the ALCT is deficient and includes sign posts amidst the wreckage pointing out how the theory of this Article might correct the identified deficiencies. Second, the alternative analysis using the structure of Code section 547(b) itself is discussed. Its yellow brick path is followed in reviewing key elements of the prima facie voidable preference as they apply to letters of credit, commencing with how issuance of a letter of credit is a transfer of debtor property. Third, the defense of "substantially contemporaneous exchange" is considered in section 547(c)(1). This defense strongly shields the bank in a letter of credit case, even if issuance of the letter of credit is the beneficiary's voidable preference. The efficacy of this defense requires a careful interpretation of section 547(c)(1) and a *repeal* of the misguided use of the independence principle as a matter of federal law. Lastly, the risks a bank and a beneficiary face are analyzed when the beneficiary draws on a letter of credit that itself is a voidable preference.

DEFICIENCY OF THE CLASSIC ANALYSIS

In the classic ALCT, the letter of credit is issued to support antecedent debt during the preference period. The bankruptcy trustee can plead a prima facie case against TBC because TBC has received the benefit of the security interest transferred to IB. Meanwhile, IB is the initial transferee of the security interest that benefited TBC on antecedent debt. Section 547(b)(1) indicates that the security interest is voidable, because the security interest benefited TBC, even though it was transferred to IB contemporaneously with IB's issuance of the letter of credit.[13] Thus, the prima facie case against TBC *is likewise valid against IB.* That IB issued the letter of credit contemporaneously with receipt of the security interest is of no matter.

11. 11 U.S.C. § 547(c) (1994).
12. 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).
13. 11 U.S.C. § 547(b)(1).

This is nothing but the result in *Levit v. Ingersoll Rand Financial Corp.* (*Deprizio*)[14]—one of the famous commercial cases of the age. In *Deprizio*, ordinary outside creditors made loans to a corporation supported by shareholder guaranties. The corporation paid back the debt about 100 days before its bankruptcy. As payments more than ninety days before bankruptcy do not meet the element described in section 547(b)(4)(A), the outside creditors thought they had no liability for voidable preference. But they overlooked the fact that the payments were also "for the benefit" of the insider shareholder. This insider benefited when guaranteed debt disappeared. Insiders are liable for any benefit received within *one year* of bankruptcy.[15] The payment was hence a voidable preference. Because it was voidable, the outside creditor, as initial transferee, had to give it back.

Likewise, in a letter of credit case, when IB issues a letter of credit with respect to antecedent debt owed to TBC, and when IB contemporaneously receives a security interest, the security interest is for TBC's benefit and is a prima facie voidable preference insofar as TBC is concerned. IB, as initial transferee, must give it up (absent a defense).

In 1994, Congress attempted to repeal *Deprizio*;[16] however, it is not clear that the repeal was successfully executed.[17] Even if it were, the amendment merely saves transfers to regular outside creditors that occur more than ninety days before bankruptcy. The amendment protects *no* transfer made within the ninety-day period. Hence, if IB receives a transfer of a security interest within ninety days of bankruptcy and if TBC receives the benefit on TBC's antecedent debt, then IB is prima facie liable for the voidable preference, even though IB contemporaneously traded this security interest for new value to D. IB can only protect itself under the traditional analysis if it performs due diligence to make sure that none of the beneficiaries of its letter of credit is TBC. Diligence alone does not suffice if D and TBC give incomplete or inaccurate information to IB.

14. 874 F.2d 1186, 1192 (7th Cir. 1989). The case is universally known as *Deprizio* in honor of the debtor in that case, V.N. Deprizio & Co.

15. 11 U.S.C. § 547(b)(4)(B) (emphasis added).

16. *Id.* § 550(c).

17. According to § 550(c):

> If a transfer made between 90 days and one year before the filing of the petition—
> (1) is avoided under section 547(b) of this title; and
> (2) was made for the benefit of a creditor that at the time of such transfer was an insider;
> the trustee may not recover *under subsection (a)* from a transferee that is not an insider.

Id. (emphasis added). The repeal may not be effective because this section prevents actions *under* § 550(a). There is plenty of evidence, however, that a trustee can avoid a preference *under* 11 U.S.C. § 547(b) without reference to 11 U.S.C. § 550(a). David Gray Carlson, *Bankruptcy's Organizing Principle*, 26 FLA. STATE UNIV. L. REV 549, 588-93 (1999); Margaret Howard, *Avoiding Powers and the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 259, 267 (1995). If so, the amendment fails in its purpose.

The establishment of the prima facie case does not mean that IB must give up its collateral. There is still the matter of the section 547(c)(1) defense ((c)(1) defense).[18] If this defense exists, IB is saved. But the classic theory, by misinterpreting the "independence principle," makes this defense impossible. IB is in peril unless the classic theory can be improved.

AIR CONDITIONING

To illustrate the *Deprizio* peril with case law, in *American Bank v. Leasing Service Corp.* (*In re Air Conditioning, Inc.*),[19] D transferred a certificate of deposit to IB as collateral for a letter of credit IB contemporaneously issued to TBC to support TBC's antecedent debt.[20] The court properly saw that the security interest was transferred *to* IB, but reasoned that the transfer was *for the benefit* of TBC.[21] Hence, TBC was held liable for the value of this security interest.[22] Judge Robert S. Vance further held that TBC was not eligible for the (c)(1) defense;[23] he thought that all TBC could show was forbearance.[24] That is, he conceived the (c)(1) defense as asserting that TBC had foregone enforcement rights against D in exchange for the letter of credit.[25] Courts routinely hold that forbearance is not "new value" within the meaning of section 547(a)(2).[26]

If it is true that TBC was not entitled to the (c)(1) defense, then it should have been true that IB was liable for the security interest, because IB is the initial transferee of TBC's voidable preference. According to section 550(a)(1):

> to the extent that a transfer is avoided under section . . . 547 . . . 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 or the entity for whose benefit such transfer was made.[27]

18. According to § 547(c)(1), the trustee may not avoid a transfer "to the extent that such transfer was—

> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
> (B) in fact a substantially contemporaneous exchange . . . ."

11 U.S.C. § 547(c)(1).

19. 845 F.2d 293 (11th Cir. 1988).

20. Actually, there was a six-day gap between the issuance of the letter of credit and the delivery of the certificate of deposit.

21. *Air Conditioning, Inc.*, 845 F.2d at 299.

22. *Id.*

23. *Id.* at 298-99.

24. *Id.* at 298.

25. *Id.* at 298-99.

26. 11 U.S.C. § 547(a)(2) (1994). *See, e.g.*, Drabkin v. A.I. Credit Corp., 800 F.2d 1153, 1159 (D.C. Cir. 1986) (holding that an agreement by an undersecured creditor not to foreclose on collateral could not be treated as new value without unfairly prejudicing general creditors).

27. 11 U.S.C. § 550(a)(1).

As an initial transferee of the security interest, *Deprizio's* logic fully condemns IB as well as TBC. The reasoning of the *Air Conditioning* court is therefore self-defeating. Fortunately for IB, the trustee in *Air Conditioning* sought recovery only from TBC. The accidental creation of *Deprizio* liability, however, may be negated only if one can develop a (c)(1) defense for TBC.

Creation of the (c)(1) defense for the security interest is straightforward under our new analysis. In *Air Conditioning*, D and TBC intended that the transfer *by* the debtor (the security interest in the certificate of deposit) be contemporaneous with new value given to the debtor (the issuance of the letter of credit for D's account). Therefore, the security interest is not voidable under section 547. Because it is not voidable under section 547, the bankruptcy trustee cannot recover its value from *either* IB *or* TBC under section 550(a)(1). The preamble to section 550(a)(1) makes clear that avoidance under section 547 is the sine qua non of recovery from a beneficiary like TBC.[28] Yet the security interest is fully defended from avoidance under section 547.

The above solution to *Deprizio* liability is necessary to prevent IB from sinking alongside TBC into the pit of liability—a double liability that the *Air Conditioning* court accidentally implies. Yet, from what has been said,[29] it should be apparent that the (c)(1) defense entirely depends on the proposition that the letter of credit itself is debtor property (or proceeds of debtor property).[30] Without this assumption, TBC cannot identify "new value" given to D. To the extent the independence principle says otherwise, the (c)(1) defense is defeated. Hence, IB's position depends entirely on recognizing that the issuance of the letter of credit must be viewed as new value given to D and transferred by D to TBC.[31] Additionally, TBC must have standing to assert IB's (c)(l) defense.

In *Air Conditioning*, Judge Vance wrongly thought that the issuance of a letter of credit could not be a transfer of debtor property to TBC.[32] Yet he intuited that TBC should not receive the benefit of a letter of credit on the eve of bankruptcy.[33] Therefore, the only option for holding TBC liable for receiving a preference was to find that (i) TBC had received the benefit of a preferential security interest granted to IB and (ii) TBC had

28. *See supra* text accompanying note 25.

29. *See supra* text accompanying notes 26-27.

30. In effect, the letter of credit is purchased by D with credit extended by IB. D subsequently directs IB to deliver that credit to TBC.

31. *Accord* Reigle v. Mahajan (*In re* Kumar Bavishi & Assocs.), 906 F.2d 942, 944 (3d Cir. 1990) (finding that guaranty held new value given to the debtor); Eisenberg v. J.L. Int'l (*In re* Sider Venturers & Servs. Corp.), 33 B.R. 708, 712 (Bankr. S.D.N.Y. 1983) (same), *aff'd*, 47 B.R. 406 (S.D.N.Y. 1985).

32. American Bank v. Leasing Serv. Corp (*In re* Air Conditioning, Inc.) 845 F.2d 293, 296 (11th Cir. 1988).

33. *Id.* at 297.

no (c)(1) defense for that security interest. It was inevitable that, by unnecessarily deferring to the independence principle, Judge Vance established all the predicates of *Deprizio* liability for IB.

COMPTON

The conventional analysis of an ALCT becomes even more problematic when one considers another leading case, *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*.[34] In *Compton*, D and its bank, IB, had a security agreement under which future advances by IB would be collateralized by D's property. IB had filed the requisite financing statements long before bankruptcy. It is not clear from the case, however, whether IB committed to lend or simply was secured for any discretionary advance it cared to give.

Just before bankruptcy, TBC (an unsecured creditor) clamored for payment. D appeased TBC with IB's standby letter of credit, according to which TBC could obtain payment from IB on demand. The day after the letter of credit was issued, a bankruptcy petition was filed against D. A month later, IB honored the letter of credit by paying TBC. The bankruptcy trustee sued TBC (but not IB) for receipt of a voidable preference.[35]

TBC moved for summary judgment on the theory that it had never received debtor property. This alone could not defeat the trustee's theory because section 547(b) does not require TBC to *receive* debtor property.[36] TBC might also be liable if it benefited because someone else received debtor property.[37] Clearly, TBC might benefit when IB receives a security interest that enables the letter of credit to be issued.[38] This theory, however, could not prevail in *Compton*. According to the *Compton* court, the security interest was at least a year old when the letter of credit was issued.[39] TBC may have enjoyed benefit only one day before bankruptcy, but the *transfer* was not within the preference period. Section 547(b)(4)(A) requires a *transfer* to occur within ninety days of bankruptcy.[40] The benefit to a non-transferee might accrue the day before bankruptcy, but, without some transfer within ninety days of bankruptcy, TBC could have no prima facie liability. Hence, the invocation of "benefit" would have proved nothing in the *Compton* case.

34. 831 F.2d 586 (5th Cir. 1987), *modified*, 835 F.2d 584 (5th Cir. 1988).

35. The supplier also tried unsuccessfully to force IB to indemnify it because of the supplier's voidable preference liability. *Id.* at 596.

36. *Id.* at 589.

37. *See, e.g.*, Crafts Plus+, Inc. v. Foothill Capital Corp. (*In re* Crafts Plus+, Inc.), 220 B.R. 331, 334 (Bankr. W.D. Tex. 1998).

38. *See also Air Conditioning, Inc.*, 845 F.2d at 297 n.3 (11th Cir. 1988) (relying on "benefit").

39. *Compton Corp.*, 831 F.2d at 589. This aspect of the case was questionable for the reasons stated *infra* text accompanying notes 62-95. The authors accept this conclusion here at face value.

40. 11 U.S.C. § 547(b)(4)(A) (1994).

Judge Williams clearly saw that if TBC could obtain a letter of credit just before bankruptcy and retain any draw proceeds, voidable preference law would have been seriously undermined.[41] The question was: how could Judge Williams show a *transfer* within the ninety day preference period?

According to Judge Williams, issuance of the letter of credit itself was no transfer of debtor property—a conclusion supposedly mandated by the independence principle[42]—the very conclusion we argue against in this Article. Judge Williams thought instead that the beneficiary was an *indirect transferee* of IB's security interest.[43]

That TBC is a transferee of the security interest in the ordinary sense must be severely doubted. If this theory literally means that TBC is a Uniform Commercial Code (U.C.C.) Article 9 secured party with a right to repossess D's property, one of two things must be true. Either TBC must have been a party to a security agreement with D, or IB must have assigned the security interest to TBC. The former never occurred. Therefore, some sort of assignment theory was needed to vindicate Judge Williams's account of the transaction.

In a letter of credit case, IB is, roughly speaking, surety to TBC, and TBC the obligee of D.[44] The new *Restatement (Third) of Suretyship and Guaranty*,[45] following its ancestor, the *Restatement of Security*,[46] takes the position that the obligee is subrogated to the security interests granted to the surety.[47] This position is based on assuring that the obligee obtains the benefit of security interests issued to the surety. If followed, then security interests issued to the surety are conditionally transferred as a matter of law to the obligee as well. Such an idea would accord with Judge Williams' theory,

41. Both the bankruptcy and district courts awarded summary judgment in favor of TBC, on the erroneous premise that liability was impossible if TBC received no transfers of debtor property. The district court also erroneously ruled that the security interest to IB was not for the benefit of the supplier. *Compton Corp.*, 831 F.2d at 589.

42. *Id.* at 590-91; *see supra* text accompanying notes 1-5.

43. *Compton Corp.*, 831 F.2d at 591. Judge Williams' "indirect transfer" theory is a stand-in for the notion that the security interest was transferred *to* IB but *for the benefit* of TBC, within the meaning of § 547(b)(1). *See infra* text accompanying notes 78-92.

44. On the relation between letter of credit law and suretyship, see Boss, *supra* note 4.

45. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 29 (1995).

46. RESTATEMENT OF SECURITY § 140 (1941).

47. According to § 29 of this newer *Restatement*:

> When a secondary obligor is subrogated to the rights of the obligee, the secondary obligor may enforce the rights of the obligee against the principal obligor and against collateral for the underlying obligation of the principal obligor. Since the secondary obligor is enforcing the rights of the obligee, the secondary obligor is entitled to whatever priority the obligee would have enjoyed with respect to those collection rights.

RESTATEMENT (THIRD) SURETYSHIP AND GUARANTY § 29 cmt. a.

but this section from the *Restatement* is controversial and enjoys scant support in the case law.[48]

Furthermore, if this controversial subrogation theory is invoked, it becomes apparent that TBC is not the initial transferee, but is rather the transferee of a transferee within the meaning of section 550(a)(2). Thus, section 550(a)(2) provides: "to the extent that a transfer is avoided under section . . . 547 . . . 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— . . . (2) any immediate or mediate transferee of such initial transferee."[49] More importantly, however, TBC is entitled to the defense in section 550(b), which provides: "The trustee may not recover under section (a)(2) of this section from—(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided . . . ."[50] Because TBC took the security interest as assignee from IB to secure antecedent debt, TBC was protected from liability by section 550(b)(1). With this observation, Judge Williams's theory of TBC's liability falls apart. Whereas antecedent debt is what made TBC liable under section 547(b)(2), it also supplies the defense under section 550(b)(1).[51]

TBC was, in any case, no transferee of IB's security interest. Instead, by "indirect transfer," Judge Williams meant "benefit" of the security

48. It may also be added that the *Restatement of (Third) Suretyship and Guaranty* explicitly excludes letters of credit from its coverage. *Id.* § 4(2). But this would be too cheap a victory and so we do not rely on it. For criticism of the *Restatement's* failure to govern letters of credit, see Boss, *supra* note 4, at 1095. The principal objection to placing letters of credit under suretyship principles is that a surety may raise any defense the obligor had against payment, whereas a bank's obligation to honor the letter of credit is not so conditioned. *Id.* at 1094-96; *see also* Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357, 362 (3d Cir. 1992) (discussing Article 5 which states in relevant part: "viewed in its entirety, evinces an intent to keep the law of guarantee and the law of letters of credit separate").

Some courts deny that IB is ever subrogated to the rights of TBC in D's collateral. *In re* Agrownautics, Inc., 125 B.R. 350, 353 (Bankr. D. Conn. 1991) (involving an issuer who "chose not to bargain for the protection of the [beneficiary's] mortgage, presumably being content with the credit worthiness of the [applicant]"); Beach v. First Union Nat'l Bank (*In re* Carley Capital Group), 119 B.R. 646, 650 (W.D. Wis. 1990) (denying equitable subrogation when the plaintiffs demanded consideration for their actions and could have required security but did not). *See generally* DOLAN, *supra* note 1, ¶ 7.05[2][b]. These cases would obviously preclude the possibility that TBC is the initial transferee of IB's security interest, in voidable preference cases.

49. 11 U.S.C. § 550(a)(2) (1994).

50. *Id.* § 550(b).

51. The defense of § 550(b) requires good faith and absence of knowledge of the voidable transfer. To be sure, some TBCs may not pass this test but others surely will. Securing an antecedent debt cannot be per se bad faith because it is expressly contemplated by the defense. Additionally, many creditors will not have "knowledge" that the transfer is voidable.

interest that was transferred to IB.[52] This is shown in the following passage:

> The federal courts have long recognized 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, circuitry of arrangement will not avail to save it." To combat such circuitry, the courts have broken down certain transfers into two transfers, one direct and one indirect. The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party.[53]

In this passage, Williams invokes some outmoded concepts from the Bankruptcy Act of 1898 (Bankruptcy Act). Under section 60(b) of the Bankruptcy Act, the trustee could only recover from a "transferee."[54] Yet, section 60(a) condemned transfers for the benefit of non-transferees.[55] The "two transfer" theory was therefore invented to explain why beneficiaries could be sued under section 60(b) of the old Bankruptcy Act, when they had never received any property.[56] This exportation of benefit of TBC became a transfer of property solely to subvert the jurisdictional limits in section 60(b). Such a strained interpretation is no longer necessary. Today, Bankruptcy Code section 550(a)(1) extends liability to "the entity for whose benefit such transfer was made."[57] Hence, the "two transfer" theory has been retired as no longer useful.[58]

52. American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293, 296 (11th Cir. 1988) (assuming that "indirect transfer" and "benefit" are the same thing).

53. Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 591-92 (5th Cir. 1987), *modified*, 835 F.2d 584 (5th Cir. 1988) (quoting National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178, 184 (1912)).

54. Bankruptcy Act § 60(b) (1898) (repealed 1978).

55. *Id.* § 60(a).

56. *See, e.g.*, Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1196 n.6 (7th Cir. 1989) (stating that the "two transfer" theory said to be "an heuristic device to explain how recoveries could be had from indirect beneficiaries under the 1898 Act").

57. 11 U.S.C. § 550(a)(1) (1994).

58. *See* Clark v. Balcor Real Estate Fin., Inc. (*In re* Meredith Hoffman Partners), 12 F.3d 1549, 1557 (10th Cir. 1993); Official Unsecured Creditors Comm. v. United States Nat'l Bank (*In re* Suffola, Inc.), 2 F.3d 977, 981-82 (9th Cir. 1993); Ray v. City Bank & Trust Co. (*In re* C-L Cartage Co.), 899 F.2d 1490, 1494-95 (6th Cir. 1990) ("The approach incorrectly equates 'transfer' with 'benefit received.' "); Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1195 (7th Cir. 1989) (the *Deprizio* case); Lawrence Ponoroff, *Now You See It, Now You Don't: An Unceremonious Encore for Two-Transfer Thinking in the Analysis of Indirect Preferences*, 69 AM. BANKR. L.J. 203, 214 (1995) (chronicling the abandonment of two-transfer theory). In

Under the Bankruptcy Code, what Judge Williams called TBC's "indirect transfer" is more properly called a *benefit.*[59] That is, the security interest was transferred to IB. TBC enjoyed benefit from this transfer and so is equally condemned under section 547(b)(2).[60] TBC has no property interest in IB's collateral, however, unless state-law principles of subrogation are applicable.[61]

TIMING OF COMMITMENTS

In assessing the prima facie voidness of IB's security interest, one must time the creation of that security interest to see if it falls inside or outside the preference period. The U.C.C. defines giving value as merely *committing* to lend. According to U.C.C. section 1-201(44): "[A] person gives 'value' for rights if he acquires them (a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon."[62]

Attachment, of course, is defined as having three elements: (i) the parties have agreed to create the security interest, (ii) the debtor has rights in the collateral, and (iii) the creditor has given value within the meaning of U.C.C. section 1-201(44).[63] Thus, if the debtor already owns the collateral, IB's security interest might be older than the letter of credit. For preference purposes, timing is governed by the complex rules of Bankruptcy Code section 547(e)(2).[64] In effect, these rules hold that the security interest is a transfer when the security interest *attaches* (if perfection follows within ten

Deprizio, Judge Frank Easterbrook did not so much deny that "benefit" might be a transfer. Rather, he insisted that "transfer" must be analyzed from the debtor's perspective, not from the multiple creditors' perspective. Even if the creditors received two transfers, the debtor made only one—and it benefited insiders.

> The two-transfer approach equates "transfer" with "benefit received". Both Lender and Guarantor gain from payment, and each receives a "transfer" to the extent of the gain. The Code, however, equates "transfer" with payments made. Section 101(50) . . . says that a transfer is a disposition of property. Sections 547 and 550 both speak of a transfer being avoided; avoidability is an attribute of the transfer rather than of the creditor. While the lenders want to define transfer from the recipients' perspectives, the Code consistently defines it from the debtor's. A single payment therefore is one "transfer," no matter how many persons gain thereby.

Levit, 874 F.2d at 1195-96.

59. Actually, Judge Williams also recognized that TBC received benefit *as well as* an indirect transfer. He does so in the course of invoking § 550(a)(1), which makes beneficiaries liable for what the initial transferee has received. Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 595 (5th Cir. 1987), *modified*, 835 F.2d 584 (5th Cir. 1988). However, he fails to make the point under § 547(b)(1).

60. *Compton Corp.*, 831 F.2d at 595; *see also* 11 U.S.C. § 547(b)(2).

61. *See supra* text accompanying notes 47-51.

62. U.C.C. § 1-201(44) (1995).

63. *Id.* § 9-203(1).

64. 11 U.S.C. § 547(e)(2).

days) or when the security interest is *perfected* (if perfection occurs more than ten days after attachment).[65]

To execute its chronological chore, a court must always consider when the commitment to extend credit was actually made. In some cases, the commitment is made at or near the time the letter of credit is issued. In other cases, the commitment will be found in loan documentation long before executed by IB and D.[66]

These lines may have been blurred in *Compton*, where IB operated under a security agreement with a future advance clause executed in 1980, almost two years previous to the bankruptcy. Judge Williams reasoned that D therefore transferred the security interest to IB in 1980,[67] even though IB

65. According to § 547(e):

> (2) For the purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made—
>
> (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time, except as provided in subsection (c)(3)(B);
>
> (B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or
>
> (C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—
>
> (i) the commencement of the case; or
>
> (ii) 10 days after such transfer takes effect between the transferor and the transferee.
>
> (3) For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

Id. § 547(e)(2), (3).

66. The U.C.C. provides definitional help to distinguish discretionary advances from advances made pursuant to an earlier commitment. According to U.C.C. § 9-105(1)(k): "An advance is made "pursuant to commitment" if the secured party has bound himself to make it, whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation . . . . " U.C.C. § 9-105(1)(k).

Hence, an advance is pursuant to a commitment even if IB might have been relieved of its obligation by the occurrence of a condition subsequent. Even the condition of IB's subjective feelings of nervousness might exist, without making the advance discretionary—provided these feelings are "not within [the secured party's] control."

In *Boers v. Payline Systems, Inc.*, 928 P.2d 1010 (Or. Ct. App. 1996), a law firm had a security interest and performed services after accounts were garnished. These services were held to be "pursuant to commitment," because the firm could not cease representation at will. Rather, the firm had to seek court permission to withdraw. Hence, withdrawal was not entirely under the secured party's control, and the firm was deemed to have a senior security interest. *Id.* at 1013.

67. Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 591 (5th Cir. 1987), *modified*, 835 F.2d 584 (5th Cir. 1988) ("Because of the future advances clause in MBank's 1980 security agreement with Compton, the attachment of the MBank's security interest relates back to May 9, 1980, the date the security agreement went into effect."); *cf.* Luring v. Miami Citizens Nat'l Bank & Trust Co. (*In re* Val Decker Packing Co.), 61 B.R. 831 (Bankr. S.D. Ohio 1986). In *Val Decker Packing*, a bank had issued a letter of credit, but the security agreement specified that only debt evidenced by a promissory note could be brought in under the future advance clause. As a result, when the debtor finally did sign a

issued the letter of credit the day before bankruptcy in 1982. According to Judge Williams:

> The transfer to [the bank] of the increased security interest was a direct transfer which occurred on May 6, 1982, when the bank issued the letter of credit. Under 11 U.S.C. §547(e)(2)(A), however, such a transfer is deemed to have taken place . . . at the time such transfer "takes effect" between the transferor and transferee if such transfer is perfected within 10 days. The phrase "takes effect" is undefined in the Bankruptcy Code, but under Uniform Commercial Code Article 9 law, a transfer of a security interest "takes effect" when the security interest attaches. Because of the future advances clause in [the] 1980 security agreement . . . the attachment of the . . . security interest relates back to . . . the date the security agreement went into effect.[68]

This relation back of the security interest to the time of the security agreement was correct only if the governing loan agreement committed IB to make advances—a point by no means proven by Judge Williams. If the advance had been discretionary on the part of IB, the security interest for that advance would have arisen only when the advance was made.[69]

Judge Williams answered this point by citing Texas Business and Commerce Code Annotated section 9-312(g), which "specifies that for purposes of priority among competing secured parties, the security interest for a future advance has the same priority as the security interest for the first advance. Conflicting security interests rank according to priority in time of filing or perfection."[70] Thus, Williams implied that, because priority for some earlier advance existed long before the preference period, priority for advances during the preference period must relate back.

This, however, is faulty analysis. U.C.C. section 9-312(5) governs the priority between secured parties, which is not at stake in *Compton.* As between secured parties, priorities are governed by the rule of "first to file

note, the debt came under the security agreement, and a security interest finally attached. Unfortunately, it attached during the preference period and constituted a voidable preference for IB. The restrictive future advance clause therefore had the effect of a "deferred attachment" clause, with the usual disastrous consequence that such clauses have. *Id.* at 842-43.

68. *Compton Corp.*, 831 F.2d at 591. Elsewhere, Judge Williams remarks: "The bottom line is that the direct transfer of the increased security interest to [the bank] is artificially deemed to have occurred at least by May 7, 1981, the date [the bank] filed its final financing statement, for purposes of a preference attack against the bank." *Id.* (footnote omitted). If the financing statement (not attachment) supplies the date of the transfer, then Judge Williams should have cited Code § 547(e)(2)(B) as the applicable rule, not § 547(e)(2)(A) that points to the time of attachment. Attachment occurred on May 9, 1980 (or so Judge Williams assumed). The financing statement to which Williams referred was not within the 10-day grace period of Code § 547(e)(2)(A). *See* 11 U.S.C. § 547(e)(2)(A), (B).

69. U.C.C. § 9-203(1)(b).

70. *Compton Corp.*, 831 F.2d at 591 n.4; *see* TEX. BUS. & COM. CODE ANN. § 9.312(g) (West 1995).

or perfect."[71] That is to say, priorities under U.C.C. section 9-312(5) do not necessarily turn on *perfection* and *attachment* but rather on filing. Filing without attachment is not perfection.[72] A secured party (who was the first to file) making a discretionary advance after an earlier secured party has filed might indeed take priority, even though the second to file was the first to perfect. But Bankruptcy Code section 547(e)(2)(A) implies *attachment* and *perfection*—not filing.[73] Hence, Code section 547(e)(2)(A) requires that a security interest is not created until the discretionary advance is actually made. In short, the security interest should have been deemed transferred when the discretionary advance of credit via issuance of the letter of credit was accomplished—the day before bankruptcy.[74] Only if IB was committed to issue the letter of credit in 1980 was Judge Williams correct in identifying 1980 as the proper time.

Separate and apart from this, Judge Williams' conclusion potentially violated section 547(e)(3), which provides, "[f]or the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred."[75] Judge Williams did not describe the collateral claimed by IB, but if D acquired any of the collateral after the security agreement was signed in 1980, then dating the transfer back to the time of the security agreement transgressed section 547(e)(3).

Although the letter of credit in *Compton* may have been a discretionary advance, assume that issuance of the letter of credit (May 6, 1982) constituted an advance pursuant to a commitment embodied in a loan agreement supported by the security agreement executed at the initial closing (May 9, 1980) and that the collateral was owned by D at that time. Suppose, for example, that, in 1980, IB committed to lend, subject to various conditions described in the loan agreement. On these assumptions, IB received a security interest in 1980. In exchange, D has a contract right against IB. This commitment to lend constitutes D's general intangible property.[76]

We suggest that, in effect, it is proceeds of this general intangible that are transferred to TBC when IB issues the letter of credit to TBC at D's request. When this occurs, IB's security interest will be older than the transfer of property to TBC. Thus, it is very possible that the security interest is not voidable because it is more than ninety days old. But the

71. U.C.C. § 9-312(5)(a) (emphasis added).

72. *See id.* § 9-303(1).

73. 11 U.S.C. § 547(e)(2)(A).

74. *See* David Gray Carlson & Paul M. Shupack, *Judicial Lien Priorities Under Article 9 of the Uniform Commercial Code: Part I*, 5 CARDOZO L. REV. 287, 346-52 (1984) (describing the difference between attachment principles and priorities between competing secured parties, when an advance is discretionary).

75. 11 U.S.C. § 547(e)(3).

76. U.C.C. § 9-106 (" 'General intangibles' means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money.").

letter of credit is issued in the preference period. Under our analysis, such a transfer might be a voidable preference even if the creation of the security interest is not.[77]

INDIRECT TRANSFERS

Judge Williams, however, wed himself to the proposition that the debtor could not have any property interest in the letter of credit itself—a proposition supposedly demanded by the independence principle. But intuiting that TBC should nevertheless be liable, Judge Williams ruled that TBC was the indirect transferee of IB's security interest.[78]

This decision put Judge Williams in a bind, insofar as section 547(b)(4)(A) was concerned. He had just ruled that IB received its security interest more than a year before bankruptcy.[79] If so, then how could the security interest be transferred to IB a year before bankruptcy, but to TBC only a day before bankruptcy?

We have seen that the entire idea that TBC could be a secured party under U.C.C. Article 9 is a faulty one. In order for TBC to be so regarded, TBC must either have a security agreement with D or be the assignee from IB. Obviously, D and TBC have no security agreement. Assignment is the only viable theory. Yet the thing assigned was transferred *by D* (to IB) more than a year before the bankruptcy. Even if we say that IB assigned the security interest to TBC one day before bankruptcy, how could that transfer—which did not involve the debtor—affect the timing of the debtor's initial transfer?

Judge Williams solved this puzzle as follows:

> The relation back provision of 11 U.S.C. § 547(e)(2)(A), however, applies only to the direct transfer of the increased security interest to [IB]. The indirect transfer to [TBC] that allegedly resulted from the direct transfer to [IB] occurred on May 6, 1982, the date of issuance

77. For an interesting puzzle beyond the scope of this Article, suppose that IB has committed to lend to D. D then signs a second security agreement with *X*, making all the debtor's property collateral for *X's* loan (including all general intangibles). Does *X* now have a lien on IB's commitment to lend? If so, can *X* claim the letter of credit issued to TBC because this letter is proceeds of D's general intangible?

We only observe that, if the letter of credit is deemed proceeds of D's general intangible right under the loan facility with IB, *X* has a perfected security interest for only 10 days. U.C.C. § 9-306(3). The financing statement for the general intangible does not suffice to perfect a security interest in the letter of credit. *Id.* § 9-104(m). Article 9 does not apply to letters of credit. *Id.* Unperfection helps TBC, but by no means does it guarantee that TBC will not be liable to *X* for the value of the letter of credit.

As these matters have nothing to do with voidable preference law, we leave them for another day.

78. Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 596 (5th Cir. 1987), *modified*, 835 F.2d 584 (5th Cir. 1988).

79. *Id.* at 591.

> of the letter of credit. The relation back principle of 11 U.S.C. § 547(e)(2)(A) does not apply to this indirect transfer to [TBC]. [TBC] was not a party to the security agreement between [IB] and [D]. So it will not be able to utilize the relation back provision if it is deemed to have received an indirect transfer resulting from the direct transfer of the increased security interest to [IB]. [TBC], therefore, cannot assert either of the two defenses to a preference attack which [IB] can claim. [TBC] did not give new value under § 547(c)(1), and it received a transfer within 90 days of the filing of [D's] bankruptcy petition.[80]

In this passage, Judge Williams refers to IB's security interest as an "indirect transfer." We have already seen that this really means "benefit" from the transfer made to IB.[81]

Judge Williams nevertheless suggests that IB is entitled to the "relation back" of section 547(e)(2)(A)[82] because IB has a security agreement with the debtor. In other words, section 547(e)(2)(A) refers to the concept of "attachment," and so IB could assert section 547(e)(2)(A) as timing the transfer in 1980. TBC, however, could not claim attachment because TBC had no security agreement with D.

This is a good point. TBC cannot claim attachment and indeed for that reason cannot claim to be a transferee of the security interest at all.[83] But the "transfer" TBC received must have occurred at *some time*. The timing rule of section 547(e)(2) provided three different rules.[84] Which one does apply to TBC, if section 547(e)(2)(A) does not? We cannot say that section 547(e)(2)(B) applies because this provision requires TBC to have perfected (outside the ten-day grace period).[85] Yet TBC never perfected at all (because TBC had no security interest directly from D). We cannot apply section 547(e)(2)(C), because that makes every single letter of credit on antecedent debt a voidable preference, even though TBC obtained payment more than ninety days before bankruptcy.[86] In short, Judge Williams's view generates no timing rule that could apply to TBC's "indirect transfer."

80. *Id.* (footnote omitted).

81. *See supra* text accompanying notes 52-61.

82. In the above passage, Williams suggests that § 547(e)(2)(A) is a "relation back" rule. This is misleading. Section 547(e)(2)(A) makes attachment the relevant moment of the transfer—which is what state law requires. It is § 547(e)(2)(B) that *defers* the time of transfer to a later time—the time the transfer is "perfected." Perfection is related to notification to the world—not to creation of the lien. Hence, it is misleading to think that Code § 547(e)(2)(A) is a relation back idea. *See* 11 U.S.C. § 547(e)(2)(A), (B) (1994).

83. We have suggested that perhaps TBC was an initial transferee of the security interest under a subrogation principle drawn from the *Restatement (Third) of Suretyship and Guaranty. See supra* text accompanying notes 44-47.

84. 11 U.S.C. § 547(e).

85. *Id.* § 547(e)(2)(B).

86. *Id.* § 547(e)(2)(C).

These observations prove that Judge Williams' rationale does not work. Section 547(b) condemns transfers of debtor property. The only transfer Judge Williams conceded to exist was IB's security interest. This Judge Williams stated was transferred more than a year before bankruptcy. TBC's benefit, however, arose during the preference period. "Benefit" was within the ninety-day period, but section 547(b) only strikes at *transfers* within ninety days.[87] If such a transfer exists, the creditor who *benefited* might be held liable (under section 550(a)(1)[88]). But where the transfer is outside the preference period and the benefit is inside the preference period, then no preference case against the beneficiary can be made.

The great Vern Countryman famously scorned a theory that held security interests were transferred for preference purposes when a U.C.C. Article 9 financing statement was filed—even though attachment had not yet occurred.[89] He called this theory the "Abracadabra" theory, or the doctrine of "The Transfer Occurred Before It Occurred."[90] In effect, the *Compton* case involves the converse—the transfer occurred after it occurred, according to Judge Williams.

The only theory that logically supports TBC's liability (when the security interest is pursuant to a commitment before the preference period) is to recognize that TBC is an indirect transferee of debtor property with regard to *proceeds* of a commitment to extend credit (here, the letter of credit)—not an indirect transferee of the security interest granted to IB. "Transfer" is a defined term in the Bankruptcy Code. According to section 101(54), " 'transfer' means every mode, *direct or indirect*, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."[91] Thus, when D ordered IB to issue a letter of credit, not to itself but to TBC (using up its committed credit from IB), the debtor "indirectly" conveyed *its own property* to TBC. It cannot be said, however, that TBC is the transferee of the *collateral* reserved for IB.

In short, there are two genuine, separate and distinguishable transfers of debtor property in cases involving letters of credit with secured reimbursement obligations: (i) the security interest to IB and (ii) issuance of the

87. *See id.* § 547(b)(4)(A).

88. *See id.* § 550(a)(1).

89. This was the theory advanced in the landmark cases of *DuBay v. Williams*, 417 F.2d 1277, 1287-88 (9th Cir. 1969), and *Grain Merchants v. Union Bank & Savings Co.*, 408 F.2d 209, 217 (7th Cir. 1969). This theory has been expressly overruled in Code § 547(e)(3). *See* Braunstein v. Karger (*In re* Melon Produce, Inc), 976 F.2d 71, 76 (1st Cir. 1992).

90. Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 793 (1985); Vern Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269, 277 (1970).

91. 11 U.S.C. § 101(54) (emphasis added).

letter of credit to TBC. Only the latter is a genuine "indirect transfer" of D's property. As this indirect transfer of D's property occurred within the preference period, TBC was justly held liable.

In contrast, if we insist on the primacy of the independence principle, then TBC could not have been held liable in *Compton.* The one and only transfer would then be IB's security interest (*ex hypothesi* outside the preference period). Under these circumstances, voidable preference law is easily circumvented. Rather than taking transfers directly from D, TBC need only procure a letter of credit through D's bank—at least where IB has "committed" at some level to extend credit under a secured loan facility more than ninety days old.

THE WAY FORWARD

Thus the independence principle, traditionally applied, both creates *Deprizio* liability in ALCTs such as *Air Conditioning* (jeopardizing legitimate security interests granted to banks) and creates a metaphysical nightmare in ALCTs such as *Compton* (where security interests and, perhaps, commitments preexisted the ALCT). In *Compton*-type situations, truly contorted analysis is required to hold TBC liable for its misdeeds.

The independence principle, however, should not be permitted to wreak havoc either on security interests or on preference law. The independence principle derives from state law. Bankruptcy has the honor of being federal law. Although courts often defer to state law when evaluating whether a bankruptcy trustee inherits a debtor's property rights,[92] federal law must preempt any principle, however cherished, that mere state law[93] has to offer.[94] Thus, nothing in the independence principle as such can insure that letters of credit are immune from bankruptcy avoidance in the ways that lead to such difficulties as are outlined above. Any such principle of immunity must be generated only by federal law. The independence principle simply does not have such an exalted status that courts must pay it homage, while federal bankruptcy law is twisted and turned beyond recognition to achieve correct substantive results.

By and large, federal bankruptcy law is content to permit the independence principle to do its work. The bankruptcy trustee inherits no property interest in the bank's obligation to honor the letter of credit. The letter of credit belongs entirely to the beneficiary. Accordingly, bankruptcy's noto-

92. *See id.* § 541(a)(1) (stating that the estate consists of all legal and equitable property rights of a debtor).

93. Many states (including New York) permit banks to stipulate that the Uniform Customs and Practice for Documentary Credits shall apply to the exclusion of the U.C.C. *See* DOLAN, *supra* note 1, ¶ 4.05, at 4-21.

94. *See id.* ¶ 7.03[3][a], at 7-16.

rious automatic stay does not enjoin the bank's actual payment of the letter of credit.[95]

If our alternate formulation is adopted, and the issuance of a letter of credit is seen as a transfer of account party property, it will be the security interest, not the letter of credit, that stands like a galled rock in the wild and wasteful swill of bankruptcy—and only if, as we suggest, federal law overrides the independence principle. If a federal override is rejected, not only TBC but IB may be liable for the security interest received by IB. Hence, far from helping the letter of credit business, the independence principle impedes it, if the logic of voidable preference law is ruthlessly pursued.

THE PRIMA FACIE ELEMENTS OF A VOIDABLE PREFERENCE

Bankruptcy Code section 547(b) sets forth six familiar elements[96] of the trustee's cause of action: (i) the debtor property has been transferred;[97] (ii) the debtor property has been transferred "to or for the benefit of a creditor";[98] (iii) the transfer was "for or on account of an antecedent debt owed by the debtor before such transfer was made";[99] (iv) the transfer was made at a time when the debtor was insolvent;[100] (v) the transfer was made on or within ninety days of bankruptcy[101] (or within one year of bankruptcy, in the case of insiders);[102] and (vi) the transfer allowed the creditor to receive more than the creditor would have received if the preference

95. *See, e.g.*, Braucher v. Continental Ill. Nat'l Bank & Trust Co. (*In re* Illinois-California Express, Inc.), 50 B.R. 232, 235 (Bankr. D. Colo. 1985); Page v. First Nat'l Bank (*In re* Page), 18 B.R. 713, 715-16 (D.D.C. 1982).

96. Some courts think there are more than six. *In re* Smith, 966 F.2d 1527, 1535-37 (7th Cir. 1992); Lingley v. Stuart Shaines, Inc. (*In re* Acme-Dunham Inc.), 50 B.R. 734, 737 (D. Me. 1985) (stating that "in addition to the express statutory requirements of a preference, many courts . . . have held that for a transfer to be preferential in the forbidden sense, it must 'diminish the fund to which creditors of the same class can legally resort for the payment of their debts' ") (quoting Kapela v. Newman, 649 F.2d 887, 892 (1st Cir. 1981)); *see also* Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1355-56 (5th Cir. 1986). For an attack on this "diminution" requirement, see Thomas M. Ward & Jay A. Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U. L.Q. 1, 40-41 (1983).

97. This requirement appears in the preamble of § 547(b).

98. 11 U.S.C. § 547(b)(1).

99. *Id.* § 547(b)(2).

100. *See id.* § 547(b)(3). The debtor is presumed to be insolvent during the 90-day preference period of § 547(b)(4)(A). *See id.* § 547(f).

101. *See id.* § 547(b)(4)(A).

102. *See id.* § 547(b)(4)(B).

had never been obtained and the creditor received a distribution from a hypothetical liquidation proceeding.[103]

Once the prima facie case is met, creditors might still escape liability if they can establish one of the statutory defenses under Code section 547(c). Of key importance in the context of letters of credit is the defense in section 547(c)(1)—the defense of "contemporaneous exchange." According to this defense, "to the extent" an exchange of debtor property (A) was *intended* to be contemporaneous with the contribution of "new value," and (B) was *substantially* so, a creditor has a defense.[104] This defense will be routinely available, especially to save the issuing bank from liability when the beneficiary has received a letter of credit on antecedent debt.

DEBTOR PROPERTY

The conclusion that the issuance of a letter of credit is the transfer of the account party's property is thought to contradict the independence principle.[105] But in voidable preference cases, this principle, like Denmark's ear, is rankly abused. The independence principle properly states—as a matter of mere state law—that, once the letter of credit is issued, D has permanently alienated property to TBC.[106] Voidable preference law does not contradict the independence principle, but only supplements it by establishing that the letter of credit and its proceeds contingently belong to the bankruptcy estate, provided all the elements of a voidable preference action can be proved.

That a letter of credit has its origin in the account party's estate can be seen easily if we trace it antecedents. Before the letter of credit is issued, D and IB will have entered into an executory contract for the issuance of the letter of credit and the related reimbursement of any draws. Often, this executory contract is a pre-existing loan facility long antedating the issuance of the letter of credit. Sometimes, the executory contract is created shortly before the letter of credit is issued. Upon formation of the

103. Section 547(b)(5) provides that a transfer is a voidable preference if it enables such creditor to receives more than such creditor would receive if—"(A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title." For metaphysical information on this "hypothetical liquidation test," see David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. ILL. L. REV. 211, 256-79. The current problem presents no difficulties under this test, and so we will spend little time on it.

104. *See* 11 U.S.C. § 547(c)(1).

105. *See* American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293, 296 (11th Cir. 1988); Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 589-90 (5th Cir. 1987), *modified*, 835 F.2d 584 (5th Cir. 1988).

106. For this reason, the automatic stay does not prevent the beneficiary of a letter of credit from receiving payment from the issuing bank. *See supra* text accompanying notes 1-6. This, at least, is so when the letter of credit is itself not a voidable preference.

contract, D has a conditional contract right against IB—what the U.C.C. calls general intangible property.[107] This general intangible is IB's commitment to extend a specified amount of credit to D. A commitment to extend credit may be in the form of a commitment to make loans, to issue letters of credit, or both.[108]

Later, IB meets its commitment to lend by issuing the letter of credit to TBC. The letter of credit is proceeds of D's general intangible property. When the letter of credit is issued to TBC, TBC has obtained proceeds of D's property–that is, D has used up a portion of its credit commitment from IB when it caused IB to issue a letter of credit to TBC. The credit commitment extended by IB to D should not have been used by D to secure (and ultimately pay) D's debt to TBC. If D instead had used the credit extended by IB to receive loan proceeds and employed those proceeds in its business (e.g., to acquire inventory or equipment), unsecured creditors would have benefited equally. The use of D's asset (i.e., the credit extension from IB) to make a transfer to TBC is impermissibly preferential.

Insofar as voidable preference law is concerned, a letter of credit should be treated no differently than a cashier's check. A cashier's check is one as to which a bank is both drawer and payor.[109] The transfer of the cashier's check is routinely said to involve a transfer of debtor property.[110] When such commonplace conclusions are handed down, no one worries that the important trade in cashier's checks is thereby threatened.

In all material respects, the status of a cashier's check is the same as that of a letter of credit. A cashier's check represents the bank's independent obligation to pay the holder. The cashier's check may be directed to a third party at the debtor's behest. When this occurs, clearly the debtor conveys his own "property" to TBC. Letters of credit are likewise nothing more than loans made by a bank to its customer, the account party,[111] but redirected at the account party's request to some third party transferee, potentially TBC.[112] These conclusions are entirely consistent with the in-

107. *See supra* note 76.

108. A harder case to describe involves D's unilateral offer to enter into a loan agreement, where the mode of acceptance by IB is actually issuing the letter of credit to TBC. Although this case is rare, it should still be seen as entailing the transfer of D's property to TBC.

109. The U.C.C. does not define "cashier's check"; some authorities think it is no different from a bank's promissory note. *See* Paul M. Shupack, *Cashier's Checks, Certified Checks, and True Cash Equivalence*, 6 CARDOZO L. REV. 467, 470 (1985). Professor Shupack suggests that cashier's checks are similar to letters of credit, with regard to the customer's ability to stop payment in case of fraud.

110. *See, e.g.*, Marathon Oil Co. v. Flatau (*In re* Craig Oil Co.), 785 F.2d 1563, 1564-65, 1568 (11th Cir. 1986) (per curiam).

111. *See* Gerald T. McLaughlin, *Letters of Credit as Preferential Transfers in Bankruptcy*, 50 FORDHAM L. REV. 1033, 1061 (1982).

112. Another commentator suggests that the letter of credit is like cash on deposit with the beneficiary. *See* Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 225-26, 242 (1985). If this is so, then, just as cash itself might be voidably conveyed, so might the letter of credit.

dependence principle. Properly understood, the independence principle does not insist that the origin of a letter of credit be other than the debtor's estate. Rather, it only insists that, when a letter of credit is issued, the debtor has permanently and irrevocably alienated its property. In short, the independence principle is a theory of alienation, not of origin. Once debtor property is alienated by issuance of the letter of credit, the debtor no longer controls the letter of credit or any decision concerning draws. In this sense, the letter of credit is independent.

We have suggested that letters of credit should be analyzed as loans by IB to its customer, D, with proceeds of that loan directed by D to TBC. Our conceptualization of the letter of credit transaction permits reconciliation of those transactions with the "earmarking" doctrine into a unified whole. This ability to put forth a unified basis for decisionmaking is a further reason to adopt this analysis.

Suppose D borrows $100 from IB for the purpose of paying TBC's antecedent debt. IB sends the $100 directly to TBC. It is often claimed that D transfers *no* property in such a case—when IB is not secured. This is the judge-made doctrine of "earmarking." Because no debtor property was transferred, it is said, TBC is innocent of voidable preference.[113] Key to the earmarking doctrine is the absence of D's control over the $100, once IB agrees to make the loan.[114] In a letter of credit case, *D's* control is never an issue precisely because of the independence principle—D has no control over draws on the letter of credit.

In contrast, where, as a condition precedent of lending to D (by directing proceeds to TBC), IB insists on a security interest from D, courts characterize the matter differently. Suppose the same $100 is sent to TBC in the same way. But now IB insists upon $120 in collateral in exchange for sending the funds. Accordingly, D and IB execute a security agreement, and IB promptly perfects its security interest. Under these circumstances, the $100 sent to TBC is deemed to be D's own property. TBC is now susceptible to voidable preference liability, if all the other elements of section 547(b) are met.[115] Yet, in the case of unsecured refinancing, the very same $100 was not D's property. Even worse, if IB was undersecured, the loan is deemed only partly property of the debtor although it is the very same loan and subject to the same controls and directions from the debtor.[116] This is absurd.

113. *See, e.g.*, Kaler v. Community First Nat'l Bank (*In re* Heitkamp), 137 F.3d 1087, 1088-89 (8th Cir. 1998); American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293, 297-98 (11th Cir. 1988); Lewis v. Providian Bancorp. (*In re* Getman), 218 B.R. 490, 492 (Bankr. W.D. Mo. 1998); James A. Rodenberg, *Letters of Credit in Bankruptcy: Can the Independence Doctrine Survive Preference Attacks?*, 96 COM. L.J. 431, 452 (1991).

114. *See* Glinka v. Bank of Vermont (*In re* Kelton Motors, Inc.), 97 F.3d 22, 27 (2d Cir. 1996).

115. *See Heitkamp*, 137 F.3d at 1089.

116. *See* Mandross v. Peoples Banking Co. (*In re* Hartley), 825 F.2d 1067, 1068 (6th Cir. 1987) (stating "[D's] interest in the $500,000 was only the value of the security interests he transferred to the third party in exchange for the third party's payment to [TBC]").

In defense of this distinction, courts point out that refinancing does not diminish the debtor's estate. Rather, such refinancing merely changes the identity of the creditors.[117] But where secured debt replaces unsecured debt, the estate is depleted, and TBC is preferred. Therefore, earmarking does not apply to secured refinancing of unsecured debt.[118] Rather, the loan proceeds are considered debtor property, and D's bankruptcy trustee may recover from TBC. These are, of course, pragmatic justifications for a distortive description, not a description of loans as such.

The earmarking doctrine has been justly criticized as a judge-made doctrine lacking a firm statutory foundation.[119] We agree with this criticism. It is unsound to base a doctrine on the artificial construct of whether loan proceeds are (or are not) property of the estate when the functional criteria used for making this determination have no real basis in the mode by which IB transfers funds to TBC. As currently described, earmarking rests upon whether or not the credit that gives rise to the loan proceeds is secured or unsecured—a factor distinct and unrelated to the debtor's power to direct application of loan proceeds. Important protection for lenders should not rest upon a fiction so feeble as this.

While we disagree with the enumerated rationale for the earmarking doctrine contained in the various reported decisions, we agree with the result achieved—the protection of TBC when it receives loan proceeds from IB on an unsecured credit. Unsecured refinancing simply changes the identity of the creditor and duplicates the effect of an assignment of the unsecured claim by TBC to IB. We also agree that when TBC receives loan proceeds from a secured loan, this protection should be unavailable. The challenge is to ground this result in the statutory language of the Code and not a fictional Wonderland where courts are required to find certain loan proceeds to be outside the estate and other proceeds to be property of the estate.

We believe this can be done by a close analysis of section 547(c)(1). According to that provision, the trustee may not avoid a transfer "to the extent that such transfer was—(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange."[120] "New value," in turn is defined in section 547(a)(2) as

117. *See Kelton Motors, Inc.*, 97 F.3d at 25.

118. *See id.* at 28.

119. *See* Harry M. Flechtner, *Preferences, Post-Petition Transfers, and Transactions Involving a Debtor's Downstream Affiliate,* 5 BANKR. DEVS. J. 1, 14-15 (1987) (stating "the oft-repeated assertion that earmarking prevents the transferred property from becoming property of the [estate] represents a misguided attempt to create a statutory basis for the judge-made earmarking doctrine, and should be rejected") (footnotes omitted).

120. 11 U.S.C. § 547(c)(1) (1994).

> money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.[121]

It is possible to apply section 547(c)(1) in a way that saves unsecured refinancing from avoidance, while condemning preferential secured refinancing.

In the case of unsecured refinancing—repayment of one unsecured debt with another unsecured debt—two transfers occur: (i) IB transfers loan proceeds to D, giving D new value and (ii) D transfers these same loan proceeds to TBC. It is this second transfer that might be a prima facie voidable preference, if we concede that IB's loan to D makes those proceeds into D's property.

To protect the transfer made by D to TBC, section 547(c)(1) requires that new value be given to D but it does not require that TBC provide the new value.[122] This section only requires *intent* and *contemporaneity*.[123]

When IB lends to D by means of wiring funds directly to TBC, the fact of a contemporaneous exchange is met automatically. In an unsecured refinancing such as this, the new value given to D is the loan proceeds. The property transferred by D is the very same loan proceeds. Thus, the new value is simultaneously the property transferred. Nothing in section 547(c)(1) prevents the application of that defense to such a situation. Similarly, the intention of a simultaneous exchange is automatically satisfied for D insofar as D intends to repay TBC with loan proceeds received from IB. Hence, the earmarking doctrine can be understood as simply an ordinary case of the (c)(1) defense.[124] *IB lending to D* by means of wiring money to TBC at D's direction in the above example is directly analogous to IB making a contingent loan to D by issuing a letter of credit at D's direction to *TBC*.

Whereas the (c)(1) defense protects unsecured refinancing, quite the opposite is true with regard to the secured refinancing of unsecured debt. In that case, three transfers occur—not two: (i) IB transfers loan proceeds to D, giving D new value; (ii) D transfers a security interest in its property to IB; and (iii) D transfers the loan proceeds to TBC. In this case, one must attend particularly to the limitation contained in section 547(c)(1) that states that a transfer may not be avoided "to the extent that such transfer was . . . for new value given to the debtor."[125] In secured refinancings,

121. *Id.* § 547(a)(2).
122. *See id.* § 547(c)(1).
123. *Id.*
124. *See id.*; *supra* note 10 and accompanying text.
125. 11 U.S.C. § 547(c)(1)(A).

there is one increment of new value—the loan by IB to D—but two transfers to which it could apply. It cannot be applied to both. Rather, section 547(c)(1) protects voidable transfers "*to the extent*" of new value.[126] "To the extent" indicates that the defense is an exhaustible asset—a finite set of loaves and fishes that must not be used to feed the multitude.

As we read this limitation, it forces a choice–one can elect to protect the security interest transferred by D to IB or to protect the transfer of loan proceeds by D to TBC. A transfer can be protected *only* "to the extent" of the new value given to D by IB. Both transfers cannot be protected.

We believe the allocation of the defense should be made to IB when IB loans funds to D. And, in the analogous letter of credit situation, the allocation of the defense should be made to IB when it issues the letter of credit. Insofar as the statute does not expressly compel allocation of the defense to either TBC or IB, we believe the allocation is driven by the following considerations, which are grounded in statutory reasoning. First, the determination is supported by the expectation of the parties—particularly the expectation of IB who supplies new value in the form of secured credit. As section 547(c)(1) makes intent of the parties the governing criterion, these expectations are appropriately invoked here.[127] In addition, allocation of the defense to IB is appropriate because the transfer of the security interest to IB is often both temporally and logically prior to the extension of credit. This is true where the grant of the security interest is a condition precedent to the issuance of the letter of credit or the making of the loan. Accordingly, the defense is already used up by the time TBC receives the transfer of the loan proceeds.[128]

This analysis can be carried over to the more complicated milieu of letters of credit transferred to secure antecedent unsecured debt. In the case where IB is unsecured, the analysis is similar to that of funding an unsecured loan. The letter of credit itself constitutes new value supplied to D. It is contemporaneous with D's redirection of this property to TBC. Hence, TBC may assert the (c)(1) defense whenever the letter of credit is on TBC's antecedent debt, and IB is unsecured. But if IB is secured, IB must use the (c)(1) defense to preserve its security interest. The defense is used up before it is available to defend TBC from liability for receiving the letter of credit on antecedent debt.

126. *Id.* § 547(c)(1) (emphasis added).

127. *Id.*

128. Allocation of the defense to IB might even be analogized to a species of purchase money priority, which favors the lender that causes the debtor's asset to come into existence. The intuition that leads to purchase money priority also leads to allocation of the § 547(c)(1) defense to IB. *See* Robert H. Skilton & Darrell W. Dunham, *Security Interests in Returned and Repossessed Goods Under Article 9 of the Uniform Commercial Code*, 17 WILLAMETTE L. REV. 779, 808 (1981).

This recharacterization of earmarking law is more satisfactory than the current accounts, and it provides a unified treatment of refinancings and letters of credit. This unified treatment is made possible by treating the letter of credit as proceeds of debtor property.

The conventional account of earmarking is an inheritance from the Bankruptcy Act.[129] Under the Act, voidable preference law had no mechanism resembling section 547(c)(1).[130] Hence, earmarking had to be described in terms of the prima facie case. In cases of unsecured refinancing, loan proceeds were proclaimed not to be debtor property, only because no other statutory mechanism was then available to express the equities of earmarking. In contrast, the same loan became debtor property if the refinancing creditor took security—even though the security was an extraneous factor. The Bankruptcy Code theorizes voidable preference law much more carefully than did the Bankruptcy Act. The old fictions necessary under the Bankruptcy Act should therefore be discarded as unnecessary, although the policy behind the fictions should be retained.[131] It is now possible to maintain that earmarking is and always was *nothing but* an imperfect attempt to articulate the defense of contemporaneous exchange now embodied in section 547(c)(1).[132] Applying the contingent loan analysis in the letter of credit context, one can locate debtor property and identify transfers, separating good from bad. Treating letters of credit as proceeds of debtor property is grounded in economic and contractual reality and, thus, on much firmer ground than the expedient fiction of "control" used in traditional earmarking cases to locate loan proceeds either inside or outside the debtor's estate.

TRANSFERS

In any ALCT, two transfers[133] can usually be identified from D to third parties. First, in establishing a line of credit, D typically transfers a security interest in collateral to IB. This security interest, of course, is not strictly necessary to obtain a line of credit or to cause the issuance of letters of credit. IB may elect to extend unsecured credit to its customer—though this is common only with investment grade credits.[134]

129. For a history, see *McCusky v. National Bank (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 565-66 (8th Cir. 1988); *see also* Carlson & Widen, *supra* note 10.

130. *See* Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n, 969 F.2d 321, 324 (7th Cir. 1992).

131. Modern courts have discarded the "two transfer" theory of beneficiary liability, precisely because it is an outmoded fiction no long necessary under the Code. *See supra* text accompanying notes 54-58.

132. *See* 11 U.S.C. § 547(c)(1).

133. In ALCTs that are not immediately followed by D's bankruptcy, there is a third transfer when D reimburses IB for draws on the letter of credit made by TBC.

134. For apparently unsecured reimbursement obligations with a non-investment grade credit, see *P.A. Bergner & Co. v. Bank One (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1113-14 (7th Cir. 1998), *cert. denied*, 119 S. Ct. 409 (1998), and *Security Services, Inc. v. National Union Fire Insurance Co. (In re Security Services, Inc.)*, 132 B.R. 411, 412, 417 (Bankr. W.D. Mo. 1991).

The second transfer that occurs from D to a third party is the issuance of the letter of credit itself—a proposition that is controversial, but which has been supported by the analysis above. This transfer is potentially voidable, when the letter of credit is issued to support TBC's antecedent debt. This second transfer is quite distinguishable from IB's security interest. The security interest is, of course, the right to sell the encumbered assets of D. The letter of credit is IB's obligation to pay according to the terms of the credit.[135]

Typically, when D causes IB to issue a letter of credit to TBC, D contemporaneously transfers a security interest to IB. It is possible, however, that these security interests might be transferred after IB has extended credit to D. For example, suppose IB issues a letter of credit on D's unsecured credit, creating a reimbursement claim against D. D thereafter secures this antecedent debt or pays it outright. On these facts, there is no synchronism between issuance of the letter of credit and the transfer from D to IB. Is such a transfer to IB "for the benefit" of TBC?[136] If so, then TBC bears liability for IB's voidable preference.

We believe any such transfer is strictly for the benefit of IB—not for TBC. TBC received the letter of credit earlier; hence, the subsequent transfer to IB is not the sine qua non of issuance of the letter of credit. TBC is indifferent to whether IB is further protected by debtor transfers or not, and so such a transfer exports no benefit to TBC.[137] In this case, TBC is not a "bad" creditor (although, for consistency of reference, we continue to use "TBC"). Thus, in *P.A. Bergner & Co. v. Bank One* (*In re P.A. Bergner & Co.*),[138] IB issued a letter of credit years before D's bankruptcy and received a transfer of security hours before IB honored TBC's draw on the credit.[139] IB was found liable for this transfer on antecedent debt. There could be no question of holding TBC liable, because TBC received no benefit from this wire transfer. IB was obligated to TBC regardless of whether D transferred funds to IB.

135. The bank's obligation to pay is always contingent on the beneficiary's tender of the documents required by the letter of credit and whatever other contingencies the letter of credit itself places on the bank's obligation to pay. But this does not change the fact that TBC has received debtor property when the letter of credit is issued. Meeting a condition is not the same as receiving a transfer. Carlson, *supra* note 103, at 235-38.

136. *See infra* text accompanying notes 140-43.

137. *See* Official Comm. of Unsecured Creditors of Baja Boats, Inc. v. Northern Life Ins. Co. (*In re* Baja Boats, Inc.), 203 B.R. 71, 74-75 (Bankr. N.D. Ohio 1996); *Security Servs., Inc.* 132 B.R. at 415; Metro Communications, Inc. v. Pacific-10 Conference (*In re* Metro Communications, Inc.), 115 B.R. 849, 854 (Bankr. W.D. Pa. 1990) (late-perfected security interest deemed no benefit to TBC); David Gray Carlson, *Tripartite Voidable Preferences*, 11 BANKR. DEVS. J. 212, 223-26 (1995).

138. 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

139. To be precise, the letter of credit obligation was $31,207,000, and the wire was $31 million. IB was, however, wrongly held liable for the greater amount. *See infra* text accompanying notes 200-13.

We have argued that issuance of a letter of credit is a transfer from D to TBC (mediated through IB).[140] If the issuance is not a voidable preference, then D has alienated this property forever once the letter of credit is issued.

From this it follows that, where issuance of the letter of credit is not itself a voidable preference, proceeds of the letter of credit cannot be viewed as D's property. Here the independence principle works legitimately to place TBC beyond preference attack.[141] The important predicate of this immunity, however, is that issuance of the letter of credit itself was not a voidable preference.

If issuance of the letter of credit is a voidable preference, the matter entirely changes because the trustee has a property interest in the letter of credit (and its draw proceeds). In such a case, TBC holds the letter of credit in trust for the bankruptcy estate. If TBC obtains proceeds of this trust *corpus*—i.e., if IB pays TBC—TBC is presumed to have drawn for the benefit of the bankruptcy trustee and so holds the proceeds in trust.[142] Hence, proceeds of a voidably issued letter of credit can be recovered as such by the trustee from TBC (assuming the trustee has jurisdiction over TBC). If TBC is insolvent, recovery would depend upon proceeds being traced or identified in the estate of TBC.

TO OR FOR THE BENEFIT OF A CREDITOR

The last few sections have emphasized that two transfers of debtor property occur in the typical letter of credit case: (i) D transfers a security interest to IB—though IB may choose to be unsecured and (ii) D directs the letter of credit to be issued to TBC. Each of these transfers must now be considered in light of section 547(b)(1), which requires that debtor property be transferred "to *or for the benefit of*" a creditor.[143]

With regard to the security interest, it is obviously transferred *to* IB. It is probably not transferred to TBC, unless one invokes controversial subrogation principles.[144] But without question IB's security interest is *for the*

140. *See supra* text accompanying notes 105-12.

141. The earlier cases involved letters of credit issued before the preference period and proceeds paid out during the preference period. Courts had no trouble holding TBC harmless on the strength of the independence principle. *See Metro Communications, Inc.,* 115 B.R. at 856; Boldt v. Alpha Beta Co. (*In re* Price Chopper Supermarkets, Inc.), 40 B.R. 816, 819 (Bankr. S.D. Cal. 1984); *In re* M.J. Sales & Distrib. Co., 25 B.R. 608, 614-15 (Bankr. S.D.N.Y. 1982); *see also* Perlstein v. Lambert Coal Co. (*In re* AOV Indus., Inc.), 64 B.R. 933, 935-36 (Bankr. D.D.C. 1986) (beneficiary of letter of credit transferred letter before preference period and IB paid transferees during the preference period).

142. *See* RESTATEMENT (SECOND) OF TRUSTS §§ 74 cmt. a, 202 (1957).

143. 11 U.S.C. § 547(b)(1) (1994) (emphasis added).

144. These subrogation principles are discussed *supra* text accompanying notes 44-61.

benefit of TBC in any transaction where the security interest is a condition precedent to issuance of the letter of credit.[145]

With regard to the issuance of the letter of credit—a separate transfer of debtor property—this is obviously transferred *to* TBC. The proceeds are not transferred to IB and indeed are rather transferred *by* IB at the behest of D.[146]

To summarize, IB has received a security interest, and this security interest benefitted TBC. Quite separately, TBC is the initial transferee of debtor property—contingent loan proceeds in the form of the letter of credit.

ANTECEDENT DEBT

Section 547(b)(2) requires that the transfer of debtor property be "for or on account of an antecedent debt owed by the debtor before such transfer was made."[147] How do our two transfers fare? To decide this question one must identify when a "debt" arises for purposes of the Bankruptcy Code. We must place the creation of the debt on a timeline to determine whether our transfers occur before or after the creation of debt. To have an "antecedent debt," one first must have "debt" in the statutorily defined sense.

"Debt" is defined in section 101(12) as "liability on a claim."[148] The definition of "claim," in turn, is famously broad. According to section 101(5), "claim" is defined 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.[149]

145. *See, e.g.*, American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293, 296-97 (11th Cir. 1988).

146. Any argument that IB is exposed to risk by receipt of a benefit from issuance of the letter of credit to TBC is dissipated by the so-called "nexus" requirement. *See* Carlson, *supra* note 137, at 232-36. For cases relying on the nexus requirement, see *Southmark Corp. v. Southmark Personal Storage, Inc.* (*In re Southmark Corp.*), 993 F.2d 117, 119 (5th Cir. 1993); *Travelers Insurance Co. v. Cambridge Meridian Group, Inc.* (*In re Erin Food Services, Inc.*), 980 F.2d 792, 796 (1st Cir. 1992); *Hendon v. Associates Commercial Corp.* (*In re Fastrans, Inc.*), 142 B.R. 241, 245 (Bankr. E.D. Tenn. 1992); *Ragsdale v. Bank South* (*In re Whitacre Sunbelt, Inc.*), 206 B.R. 1010, 1015-19 (Bankr. N.D. Ga. 1997); and *Crafts Plus+, Inc. v. Foothill Capital Corp. (In re Crafts Plus+, Inc.*), 220 B.R. 331, 334-35 (Bankr. W.D. Tex. 1998).

147. 11 U.S.C. § 547(b)(2).

148. *Id.* § 101(12).

149. *Id.* § 101(5).

Under this definition, future tort victims not yet injured have been said to own "claims."[150] On first reading, it appears that no contingency renders debt too remote under this definition.

In analyzing the meaning of "antecedent debt owed by the debtor" in section 547(b)(2), courts have indeed borrowed from the law of the bankruptcy claim, with its capacious definition.[151] This equation is unfortunate with regard to its effect on the status of a commitment to lend—utilized in virtually every real estate financing or leveraged financing of a sale of a company or assets.[152] Real estate financing, for example, typically involves IB's commitment to lend, conditioned on many events, such as tender of a mortgage and execution of a satisfactory loan agreement. If the Bankruptcy Code definition of "claim" governs, this commitment to lend could be seen as an antecedent debt, especially in the case where IB firmly promises to lend and D promises to borrow.[153] If the mere commitment to lend creates the "debt," then every mortgage tendered at a closing is a voidable preference (if a loan commitment preceded closing), and real estate and other committed financing bears a risk of preference liability for ninety days following the closing. Such a conclusion is unacceptable.

It might be suggested, in response, that antecedent "debt" should exist under the Code when a debt is *unconditionally* payable by D to IB.[154] The linguistic premise for this argument is that Code section 547(b)(2) does not refer to antecedent debt *simpliciter*. It refers to debt *owed by D*.[155] The premise would be that D does not owe anything until all conditions precedent to the present enforceability of that debt are met. If "antecedent debt" required D's *unconditional* obligation to pay, then the debt arises at the closing, at the same time as the mortgage is conveyed.[156]

Such a conclusion protects real estate financing, but it goes too far. If "antecedent debt" requires D's unconditional obligation to pay here and now, then D's obligation to reimburse IB for a draw on a letter of credit

150. *See* Gregory A. Bibler, *The Status of Unaccrued Tort Claims in Chapter 11 Bankruptcy Proceedings*, 61 AM. BANKR. L.J. 145, 149-50 (1987).

151. *See* Danning v. Bozek (*In re* Bullion Reserve of N. Am.), 836 F.2d 1214, 1217 (9th Cir. 1988); Energy Coop., Inc. v. SOCAP Int'l, Ltd. (*In re* Energy Coop., Inc.), 832 F.2d 997, 1001 (7th Cir. 1987).

152. *See generally* E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987).

153. Commitment letters are often read to create a duty on the debtor to borrow, as well as a duty on the creditor to lend. *See* Teachers Ins. & Annuity Ass'n of Am. v. Butler, 626 F. Supp. 1229, 1232-36 (S.D.N.Y. 1986), *appeal dismissed*, 816 F.2d 670 (2d Cir. 1987).

154. Carlson, *supra* note 103, at 242-47.

155. *See* 11 U.S.C. § 547(b)(2) (1994).

156. It is important to understand that, even though the giving of a commitment constitutes sufficient value for a security interest to attach within the meaning of U.C.C. § 9-203(1)(b), it does not follow from this that a debt owed by the debtor exists at the time a commitment is given. *See* U.C.C. § 9-203(1)(b) (1995).

does not become a debt until IB actually wires funds to TBC.[157] Under the "unconditional" definition of "debt," IB would then be free to take transfers of security from D at any time before the wire transfer from IB to TBC to pay a draw request. Indeed, IB could even delay the wire transfer honoring a draw until D paid. Such an opportunity allows IB to extend unsecured credit to D and then take preferences at will when D's bankruptcy seems imminent. This behavior is precisely what voidable preference law was designed to prevent.

Such a view—that debt must be unconditionally payable to qualify as "debt"—is not commanded by the statute. "Owed by the debtor" could easily mean "contingently owed" as well as "absolutely owed," just as "claim" means both contingent and vested claims.[158] With an eye on the consequences, we propose a middle ground between the two extremes of (i) "debt" as any theoretical debt, no matter how contingent and remote, and (ii) "debt" defined as that which is absolutely and uncontingently payable. The former finds some support in the case law, but accidentally condemns almost all committed financing to a preference risk, where the financing involves a commitment to lend. The latter permits IB to behave preferentially in letter of credit cases.

What then is the borderline between overly remote contingencies and the contingencies that fit within the definition of "debt"? We propose that the difference between the two be described this way. "Debt" might include D's contingent obligation to pay IB. But one contingency must already have occurred—the creditor must already have made the loan or advanced value—whether the value be the advance of funds, the issuance of a letter of credit, or the supply of goods and services on credit. This is a traditional analysis in cases involving contracts to sell goods—a debt arises when goods are shipped or when the contract is breached—not when the contract is executed.[159] If value has been committed, but not delivered, the commitment to lend is not debt because the creditor could not file a proof of claim seeking recovery from D's estate. Other contingencies such as presentation of documents, however, do not remove D's obligation from the definition of "debt." For example, the obligation of D to reimburse IB for any draw becomes absolute upon issuance of the letter of credit, even if a payment by D to IB is contingent upon draw.

To justify this definition and ground it in the Bankruptcy Code's statutory definitions of "debt" and "claim," we observe that a distinction exists between the commitment to lend and the actual loan, insofar as

157. *See id.* § 5-114(3) (stating that "[u]nless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit.").

158. *See* 11 U.S.C. § 547(b)(2).

159. *See, e.g.*, Nolden v. Van Dyke See Co. (*In re* Gold Coast Seed Co.), 751 F.2d 1118, 1119 (9th Cir. 1985) (holding that a debt is incurred when goods were shipped and the debtor became obligated to pay for them).

bankruptcy is concerned. If D breaches its obligation to borrow with regard to a bilateral commitment to lend, IB might have a breach of contract action, which could be a claim in bankruptcy, but this would be different from a claim for repayment of the loan itself. Hence, the actual advance—not the commitment to lend—should be the moment at which D has a claim *for the loan.* This is the moment at which "debt" arises, for section 547(b)(2) purposes.[160] In this test, the question is whether or not IB properly could file a proof of claim in a hypothetical bankruptcy proceeding of the debtor with respect to the particular "debt" in question. If the answer is *yes*, then a "debt" exists within the meaning of section 547(b)(2) and, accordingly, payments or transfers made with respect to such debt after the time such debt came into existence might satisfy the requirements of a preferential transfer.

Under such a test, when IB gives a commitment to lend money to or issue letters of credit for the account of D, the mere provision of the commitment does not create a "debt." If a bankruptcy followed the creation of the commitment, IB could not file a proof of claim either with respect to money that might have been loaned or letters of credit that might have been issued and drawn upon. However, if IB advances funds or issues a letter of credit to TBC, IB could file a proof of claim in a hypothetical bankruptcy for the amount of the loan or the expected amount of a draw, and so "debt" exists.[161]

Similarly, in the context of a sales contract, a beneficiary of a documentary credit, prior to the presentment of the bills of lading, would have no bankruptcy claim to make against D's estate. To be sure, the beneficiary's executory contract might be rejected, giving rise to a claim for damages. The claim for damages, however, must be distinguished from the claim for the price of the goods. Only when the beneficiary is entitled to the price of the goods has the beneficiary given value to D, for the purpose of establishing the time of TBC's debt.[162] For this reason, doc-

160. *See id.*

161. Even in the case where the letter of credit has not been drawn upon, a debt exists for which a proof of claim may be filed. To be sure, if the credit expires undrawn during the proceeding, ultimately no amount will be allowed. Conversely, if the credit is drawn during the proceeding, a claim will be allowed in the amount of the draw. If, however, the letter of credit is a long term standby letter of credit, where the term extends beyond the completion of the case and remains undrawn, the value of the claim will be estimated, presumably based on the face amount of the credit and an assessment of the likelihood of a draw. *See* 11 U.S.C. § 502(c). Note that § 502(e)(1) does not make IB's claim disallowed. Section 502(e)(1) prohibits a claim for a contingent claim whenever the surety is "liable with the debtor." *Id.* § 502(e)(1). IB, however, is liable on the letter of credit whether or not D has defenses. Hence, IB is not "liable with the debtor" and hence has an allowable contingent claim.

162. *See* Sullivan v. Willock (*In re* Wey), 854 F.2d 196, 200 (7th Cir. 1988) (stating that the creation of executory contract not "antecedent debt," but breach giving rise to cause of action qualifies); *Gold Coast Seed Co.*, 751 F.2d at 1119 (holding that debt is incurred upon shipment, not upon contract's execution).

umentary letters of credit are typically not voidable preferences. The beneficiary becomes entitled to the price at the same moment the bills of lading are presented to D. By this time, the transfer of D's property to the beneficiary—the very issuance of the letter of credit—has already occurred. Here we do not even have a contemporaneous exchange of goods for cash. Rather, we have a kind of *advance* payment to the beneficiary before the debt has vested and accrued.

Such a definition,[163] pragmatic though it is, succeeds in excluding commitments to lend and executory contracts, while including loans, letters of credit, and the right to the price of goods or services. This is the definition of "debt" that the authors will bring to bear on TBC and IB, to test the time of transfers against the time of debt creation.

The Beneficiary's Antecedent Debt

TBC, the "bad" beneficiary of the letter of credit, receives an indirect transfer—the letter of credit itself—from D. TBC is an initial transferee of the letter of credit. TBC also enjoys the benefit of any security interest contemporaneously transferred by D to secure D's reimbursement obligation to IB. As such, TBC is not a transferee of the security interest at all. With regard to the initial transfer of the credit or with regard to the benefit of the security interest in collateral, TBC may have no antecedent debt. If not, then both IB and TBC must necessarily escape all voidable preference liability. Two common examples can be given.

In the standard documentary letter of credit familiar in international trade, the letter facilitates secure payment to a seller of goods. The letter typically requires that the beneficiary present bills of lading stating that conforming goods have been shipped to the buyer (who will become bankrupt within ninety days).[164]

163. Perhaps this definition accords with one recently formulated by Judge John Ninfo in *Breeden v. L.I. Bridge Fund, L.L.C. (In re Bennett Funding Group, Inc.)*, 220 B.R. 739, 742 (B.A.P. 2d Cir. 1998):

> The case law is clear that for purposes of Section 547(b)(2) "an antecedent debt" is a pre-existing debt that was incurred when the debtor previously obtained a property interest in the consideration provided by the creditor that gave rise to the debt. The consideration may have been a loan or the furnishing of goods or services, but when the debtor obtained the loan, goods or services, the creditor had a claim, matured or unmatured, that it could then assert against the debtor's bankruptcy estate if payment was not made at the time a petition was filed. At that point the debt was "antecedent" for purposes of Section 547(b)(2).

In this definition, "loan" should be distinguished from "commitment to lend." Both would constitute "consideration," but only the former would give rise to antecedent debt.

164. Soon after the Bankruptcy Code was enacted, Dean Gerald McLaughlin suggested that the documentary letter of credit leads to a preference risk. The issuance of the letter of credit by IB creates antecedent debt. IB receives negotiable bills later. Inevitably, IB's security

Such a transaction involves no transfers on "antecedent debt owed by the debtor."[165] An executory sales contract will antecede the issuance of the letter of credit, but, as previously defined, executory contracts are not antecedent debt because TBC has advanced no *value* to D in the sense contemplated by the Code.[166]

By way of a second example, letters of credit are sometimes used to secure commercial paper issued by the debtor. In this type of transaction, the debtor issues short term negotiable notes.[167] The notes set forth the holder's right to the benefit of a previously established letter of credit. Because the letter of credit pre-existed the issuance of the notes, no transfer to or for the benefit of the holder of such a note can be deemed "for or on account of antecedent debt owed by the debtor before such transfer was made."[168]

These two common examples show that every letter of credit is not preferential. Indeed, preferential letters of credit will represent a tiny minority of cases—almost always involving standby credits.

Transfers on account of antecedent debt can easily arise in standby cases. These will exist when D owes TBC for a debt in existence prior to the time the letter of credit is issued. Sometimes, nervous unsecured creditors are appeased with letters of credit in order to stave off a lawsuit. When this occurs, TBC has received debtor property on antecedent debt.[169]

The Bank's Antecedent Debt

The above remarks related to the antecedent debt of TBC. They emphasized that, until TBC makes a loan, issues a letter of credit, or becomes

interest in these bills of lading arises on antecedent debt, and the bank faces a voidable preference risk in such cases. McLaughlin, *supra* note 111, at 1059-62. Separately, however, as McLaughlin acknowledges, IB is subrogated to TBC's rights under the sales contract. At least if TBC obtains negotiable bills of lading, TBC has a security interest in the goods. *See* U.C.C. § 2-505(1)(a) (1995). IB stands in TBC's shoes and can assert the security interest in the bills of lading. McLaughlin, *supra* note 111, at 1053. Hence, any security interest in bills on D's reimbursement obligation may be transfers on IB's antecedent debt. IB also obtains an assignment through subrogation of TBC's valid secured claim. This separate claim cannot be challenged, and so IB is protected in D's bankruptcy.

165. *See* 11 U.S.C. § 547(b)(2).

166. *See supra* text accompanying notes 158-59.

167. *See* DOLAN, *supra* note 1, ¶ 7.03[3][e]; Verkuil, *supra* note 1, at 722. *See, e.g.*, Boldt v. Alpha Beta Co. (*In re* Price Chopper Supermarkets, Inc.), 40 B.R. 816, 817 (Bankr. S.D. Cal. 1984).

168. 11 U.S.C. § 547(b)(2).

169. IB faces a risk that what *appears* to be a valid transaction is in fact a disguised preference. For example, suppose D owes TBC $100. D and TBC enter into a sales contract whereby TBC agrees to buy $200 of merchandise for $100, plus forgiveness of debt. IB issues a letter of credit, not knowing anything about the agreement to satisfy antecedent debt. Although IB thinks it is financing a valid transaction, it is actually participating in a preference. *See* Abramson v. St. Regis Paper Co. (*In re* Abramson), 715 F.2d 934, 935-36 (5th Cir. 1983).

entitled to the price of goods or services, there is no "antecedent debt owed by the debtor."[170] This is so even though a mere commitment to lend constitutes "value" within the meaning of the U.C.C.

This same principle, as applied to IB's debt, suggests that IB lends to D when IB issues the letter of credit to TBC. At this moment, D owes an antecedent debt to IB,[171] even though D's obligation to pay is contingent upon TBC actually drawing on the letter of credit. This identification of antecedent debt with issuance of the letter of credit coheres symmetrically with the conclusion that IB transfers debtor property to TBC at this same moment. Thus, D's reimbursement debt (i.e., D's unconditional *obligation* to reimburse) arises when the contingent loan by IB to D is made in the form of the letter of credit issued to TBC. The obligation to reimburse is unconditional even if the requirement to make payment remains contingent. Prior to issuance of the letter of credit both the obligation to reimburse and the requirement to pay are conditional. Issuance of the letter of credit is the moment at which IB could file a proof of claim in a bankruptcy proceeding for D.

The recent decision in *P.A. Bergner & Co. v. Bank One* (*In re P.A. Bergner & Co.*)[172] turns on this point. In *Bergner*, IB issued a standby letter of credit to C_1[173]—though not on C_1's antecedent debt. IB was largely an unsecured contingent creditor of D on a letter of credit. C_1 informed D that it was going to draw the full amount in its favor. IB demanded a prepayment from D—something to which IB was contractually entitled.[174] To meet this obligation, D drew down its line of credit with Swiss Bank (SB). IB received this SB transfer at 11:02 a.m. on July 19, 1991, an hour or two after C_1 presented conforming documents. At 2:11 p.m., IB wired funds to C_1 in satisfaction of its letter of credit obligation.

170. 11 U.S.C. § 547(b)(2).

171. *See* Luring v. Miami Citizens Nat'l Bank & Trust Co. (*In re* Val Decker Packing Co.), 61 B.R. 831, 841 (Bankr. S.D. Ohio 1986); Aetna Bus. Credit, Inc. v. Hart Ski Mfg. Co. (*In re* Hart Ski Mfg. Co.), 7 B.R. 465, 468 (Bankr. D. Minn. 1980); McLaughlin, *supra* note 111, at 1056. *But see* Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n, 969 F.2d 321, 326 n.5 (7th Cir. 1992).

172. 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

173. Two letters of credit existed in *Bergner*. One was issued by Bank One to AMC for goods to be shipped in the future by AMC to D. We shall refer to AMC as C_1. A second letter of credit was also issued to Liberty Mutual Insurance Company. We will refer to Liberty Mutual as C_2. The two separate letters of credit raise quite different issues and will be analyzed separately. Neither C_1 nor C_2, incidentally, were "bad" creditors.

174. *P.A. Bergner & Co.*, 140 F.3d at 1114. "Under section 1, Bergner promised to pay Bank One the amount of any draft drawn under a letter of credit issued pursuant to the SLCA 'at or before presentation of the draft' by the letter's beneficiary." *Id.* This contractual provision merely replicates the doctrine of "*quia timet*"—a suretyship idea. *See* Borey v. National Union Fire Ins. Co., 934 F.2d 30, 32 (2d Cir. 1991) (stating " '[*q*]*uia timet*' is the right of a surety to demand that the principal place the surety 'in funds' when there are reasonable grounds to believe that the surety will suffer a loss in the future because the principal is likely to default on its primary obligation to the creditor").

Properly analyzed, D owed antecedent debt to IB when IB issued the letter of credit to C_1. To be sure, D owed IB conditionally. The conditions were the presentment of conforming documents and payment of the letter to C_1.[175] But IB had already made its loan to D—when it issued the letter of credit to C_1. Thereafter, IB could not deplete D's estate on the eve of bankruptcy in order to secure or pay D's reimbursement obligation.

Bankruptcy Judge Dee McGarity seems to have agreed with this assessment. As Judge McGarity saw it, IB's contingent claim against D dated back many years. The "evergreen" letter of credit was first issued in 1989 and automatically renewed until IB canceled it effective July 31, 1991.[176] IB's receipt of payment was therefore a transfer on antecedent debt.

Yet in putting forth a general rule describing her holding, Judge McGarity remarked: "[IB] argues it was only a contingent creditor of [D], and a contingent creditor cannot hold an antecedent debt within the meaning of 11 U.S.C. § 547(b)(2). On the contrary, contingent debts are also antecedent debts."[177]

As we have suggested, this formulation goes too far.[178] It points to any debtor obligation to IB, no matter how contingent. Thus, antecedent debt to IB might exist even before the letter of credit is issued, if IB had committed to issue the letter of credit. We think the issuance of the letter of credit—not the commitment to lend—should be the time at which antecedent debt existed. Before that time, no loan had been made. The difference might be expressed the following way: under the bankruptcy court's formulation, collateral taken before the letter of credit was issued still might be preferential; under our analysis, because the issuance of the letter of credit is itself the loan to the debtor that creates a "debt," collateral provided in advance of the actual issuance of the letter of credit would not be preferential.[179]

175. *See* U.C.C. § 5-114(3) (1995) (stating that "[u]nless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit.").

176. *P.A. Bergner & Co.*, 187 B.R. at 970.

177. *See id.* at 976. On appeal, the Seventh Circuit assumes without explanation that D paid IB on antecedent debt.

178. *See supra* text accompanying notes 147-63.

179. There is some ambiguity in Judge McGarity's opinion on exactly when D's antecedent debt arose. Not only does she suggest that all contingent claims are antecedent debts, but she also hints at the opposite position—antecedent debts must be unconditional. This latter position is implied when Judge McGarity struggled to distinguish *Sullivan v. Willock (In re Wey)*, 854 F.2d 196, 200 (7th Cir. 1988), which held that "antecedent debt" does not arise when an executory contract is formed. An executory contract, of course, in some sense gives rise to a contingent claim against the debtor. Judge McGarity noted that, as of the morning of July 19, 1991, when C_1 presented conforming documents to IB, D's obligation to reimburse IB was no longer contingent, thereby proving that D's antecedent debt to IB existed. *P.A. Bergner & Co.*, 187 B.R. at 976. Later, with regard to C_2 (an entity that made no draw

In *Aetna Business Credit, Inc. v. Hart Ski Manufacturing Co. (In re Hart Ski Manufacturing Co.)*,[180] a letter of credit case from the early caveman years of the Bankruptcy Code, Judge Jacob Dim properly held that issuance of the letter of credit was the birth of debt to IB, as suggested here (and thus the point on the timeline used to evaluate subsequent transfers).[181] As IB's security interest[182] was contemporaneous with issuance of the letter of credit, the trustee's prima facie case against IB failed. But, just in case this assumption was wrong, Judge Dim also ruled that, even if the commitment to issue the letter (not the letter itself) was the birth of D's debt to IB, IB gave new value for its security interest from D.[183] The new value was the issuance of the letter of credit. This device, however, will not work to save secured loans pursuant to unsecured commitments. The issuance of the letter of credit is simply the performance of what IB was obligated to do. It was proceeds, as it were, of D's rights against IB.[184] As such, the letter of credit is "old value" that relates back to the unsecured commitment. In effect, Judge Dim attempted to double count the loan. Regarding Judge Dim's backup theory, first, the loan was given (*ex hypothesi*) when the commitment was made. Second, the loan was given when the letter of credit was issued and constitutes the stuff of a (c)(1) defense. This double-counting cannot be accepted. It is for this reason that the issuance of the letter of credit (not the earlier commitment) should be viewed as the birth of D's debt to IB.

Effects on Setoff Law

In *Bergner*, the status of the wire transfer by which IB was paid is intricately tied into the theory of a bank's antecedent debt. For the purposes of the discussion to follow, "payment" may be defined as the satisfaction of antecedent debt.[185] Wire transfers sent before the letter of credit is drawn cannot properly be characterized as "payment." Until D's obliga-

on the letter of credit until after bankruptcy), she stated that the draw was a "virtual certainty." *Id.* at 977-78.

These observations were unfortunate. First, not presentment to, but payment by IB to C_1 gives rise to D's unconditional obligation to pay IB. Thus, if IB simply refused to pay C_1, D would have a defense to IB's suit against D. Second, the implication that *all* contingencies be removed for antecedent debt to exist suggests that letters of credit might be issued and, so long as IB is put into funds before presentment, IB is permitted to take preferences. Such a definition of "antecedent debt" permits banks to avoid insolvency risks deliberately undertaken when letters of credit are issued without collateral.

180. 7 B.R. 465 (Bankr. D. Minn. 1980).

181. *Id.* at 468.

182. Actually, a secured surety guaranteed the reimbursement obligation of D. The security interest was therefore issued to the surety for the benefit of IB. *Id.* at 467.

183. *Id.* at 468.

184. We earlier characterized commitments to lend as D's general intangible property. Hence, the letter of credit would be proceeds of this property.

185. *See., e.g.*, Bronson v. Rodes, 74 U.S. 229, 250 (1868).

tion to reimburse becomes *unconditionally* due and owing to IB, IB could not use the funds to satisfy debt. Rather, IB could only credit the wire to D's checking account. The moment at which D owes IB unconditionally occurs only when IB wires funds to C_1. When this moment arrives, one is not in the realm of "payment." Rather, one has entered the realm of "setoff"—IB's power over its own debt to D. This invocation of setoff law is significant because voidable preference theories cannot interfere with IB's right of setoff, if the setoff is described in Bankruptcy Code section 553(a). According to section 553(a):

> [t]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.[186]

Hence, wire transfers from D to IB that occur before IB wires to C_1 can never be voidable preferences under section 547(b) if they give rise to valid setoff rights under section 553.[187] This is so even if IB cannot manifest its setoff immediately but can only do so when IB's claim against D becomes absolutely vested. Avoidance of the bank deposits as preferences would affect the eventual setoff right, in violation of section 553 and therefore section 553 precludes such avoidance.[188]

In *Bergner*, it will be recalled that IB had issued a standby letter of credit to C_1.[189] D was contractually obligated to put IB in funds before C_1 made any draw on its letter of credit. If D were to comply by wiring funds, IB had to credit this amount to D's bank account, but IB would have a security interest in this account. These contractual provisions do not prove, however, that D had an *unconditional* obligation to "pay" IB prior to a draw by C_1. Thus, if, after receiving funds, IB never paid C_1, then D eventually would be entitled to draw out the funds from its bank account. In effect, these contractual provisions simply constituted D's obligation to render IB secured by a certain time.

Upon learning that C_1 was about to draw, IB, pursuant to contract, demanded funds from D. C_1 made a valid draw on the morning of July 19, 1991, for $31,207,000. At 11:02 a.m., D wired $31 million to IB. Because D already had $207,000 in its bank account, IB now had sufficient funds from D to pay C_1 the required $31,207,000. Pending the wire to C_1, IB credited the wired funds to D's bank account. At 1:24 p.m., it debited $31,207,000 from D's account in order to cover the wire transfer

186. 11 U.S.C. § 553(a) (1994).

187. *See id.* §§ 547(b), 553.

188. *See id.* § 553.

189. P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1113 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

IB would make to C_1. At 2:11 p.m., IB wired $31,207,000 to C_1. D's unconditional obligation to pay IB arose only at this time, and 2:11 p.m. marks the moment at which IB had the right to set off mutual debts.[190]

Both Bankruptcy Judge Dee McGarity and Court of Appeals Judge Diane Wood ruled that IB was "paid" at 1:24 p.m., when IB "memo posted" the amount to D's checking account.[191] As Judge Wood described this event: " 'Memo posting' is a provisional internal bank process to record the transaction pending formal posting at the end of the day."[192] Posting was a prerequisite to wiring funds to C_1 under Federal Reserve regulations.[193] It perhaps signaled that IB would honor no check drawn on those funds and presented to IB after 1:24 p.m.[194] The checking account was effectively "frozen" after this time. The freezing of a checking account, however, is neither a setoff nor a transfer of property to IB.[195] Indeed, posting was a non-event.[196]

Properly speaking, the voidable preference occurred at 11:02 a.m., when IB received the wire transfer of $31 million. The wire constituted a transfer of debtor property, and, as previously seen, it was a transfer on antecedent debt. Hence, as of 11:02 a.m., IB had received a prima facie voidable preference. Between 11:02 a.m. and 1:24 p.m., D's checking account showed a positive balance of $31,207,000—of which $31 million came from the 11:02 a.m. wire. During this time, it cannot be said that any antecedent debt of D has been "paid." The hallmark of payment is the extinguishment of antecedent debt. Yet D's debt became unconditionally due and owing only at 2:11 p.m.

190. *Id.* at 1121-22; *see* McLaughlin, *supra* note 111, at 1066. Judge McGarity thought that D's unconditional obligation arose earlier—when C_1 presented conforming documents. *P.A. Bergner & Co.*, 187 B.R. at 976. But if IB never paid C_1, IB could not collect from D.

191. According to Judge McGarity:

> While unrestricted funds were property of the debtor, the subsequent restriction of those funds resulted in a transfer to the bank. . . . [B]efore the memo posting occurred, Bergner had control of the funds in its account . . . . For over two hours, from the time the money was deposited until Bank One memo posted the account, the funds were unrestricted. The memo posting froze the account and transferred control, and the debiting of the account completed the seizure, thereby changing ownership as well as control. Therefore, a prepetition transfer of Bergner's funds occurred when Bank One memo posted and took control over the $31,207,000.

P.A. Bergner & Co., 187 B.R. at 973-74.

192. *P.A. Bergner & Co.*, 140 F.3d at 1116.

193. *See P.A. Bergner & Co.*, 187 B.R. at 975.

194. *Id.* at 970-71.

195. Citizens Bank v. Strumpf, 516 U.S. 16, 19 (1995). In fairness to Judge McGarity, her opinion antedated *Strumpf* by a few months. By her lights, authority, soon to be overruled, existed to support the proposition that freezes are setoffs. Judge Wood, however, simply overlooked the determinative impact of *Strumpf*.

196. Thus, posting as a concept has been eliminated as unimportant in the recent revision of U.C.C. Article 4. *See* U.C.C. § 4-109 (1995); WIS. STAT. ANN. § 404.109 (West 1995 & Supp. 1998).

Meanwhile, the security interest in the bank account had this significance: if D were to write checks on the bank account and if these funds were necessary to secure the eventual duty of D to reimburse IB for paying C_1, IB could lawfully dishonor those checks. Hence, both these contractual provisions—the obligation to put IB in funds and IB's security interest in the checking account balance—were designed to set the stage for an eventual setoff of mutual countervailing debts.

At 2:11 p.m., IB wired $31,207,000 to C_1 in accordance with the letter of credit. At this moment, IB had the right to manifest a setoff and debit the account. This was accomplished automatically at the end of the day, when the posting became a final debit.[197]

If the trustee were to recover $31 million from IB as a voidable preference, the court properly should have analyzed the transaction first under section 553.[198] IB had a valid defense to voidable preference liability if IB's right of setoff was described in section 553(a). Section 553(a) indicates that nothing in the Bankruptcy Code can interfere with IB's right of setoff.[199]

But section 553(a) excludes three different transactions from protection. Relevant here is section 553(a)(3), which permits avoidance if "the debt owed to the debtor by such creditor was incurred by such creditor—(A) after 90 days before the date of the filing of the petition; (B) while the debtor was insolvent; and (C) for the purpose of obtaining a right of setoff against the debtor."[200] All of these elements were met in *Bergner*. The deposits were for the purpose of setting up a later setoff.[201] Because section 553(a)(3) applied, section 553(a) could provide no defense to IB. But this alone does not mean that the $31 million wire transfer was voidable. Grammatically, section 553(a)(3) is not an avoidance provision. Rather, when section 553(a)(3) applies, the preamble to section 553 is deactivated. The preamble in turn merely negates all other avoidance provisions in the Code. Hence, once section 553(a)(3) de-activates its preamble, the trustee must still locate a genuine avoidance provision to render IB liable.

197. *P.A. Bergner & Co.*, 140 F.3d at 1121-22.

198. This Judge Wood refused to do:

> [IB]'s actions seizing for itself . . . the $31,207,000 that [D] paid it in satisfaction of [D]'s debt under the SLCA . . . were therefore avoidable preferential transfers under § 547(b), which [D] is entitled to recover under § 550(a). In light of this conclusion, we have no occasion to reach the question whether the same transactions might also be viewed as setoffs subject to disallowance under 11 U.S.C. § 553(b)(1).

Id. at 1122.

199. 11 U.S.C. § 553(a) (1994).

200. *Id.* § 553(a)(3).

201. *See* McLaughlin, *supra* note 111, at 1064-65.

In contrast to section 553(a)(3), which merely limits IB's privilege against preference liability, section 553(b)(1) is a genuine avoidance provision. Section 553(b)(1) provides, in relevant part:

> if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the filing of the petition, *then the trustee may recover* from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
> (A) 90 days before the date of filing of the petition; and
> (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.[202]

The italicized language indicates that section 553(b) is an avoidance provision. No such language appears in section 553(a).[203]

In *Bergner*, section 553(b) did not clearly apply. Section 553(b) requires an "insufficiency" to antedate the actual setoff.[204] In other words, to create an insufficiency, a debt capable of setoff must have existed ninety days before bankruptcy and the debt must have exceeded the amount of any potential set-off. That did not occur in *Bergner*. IB's ability to exercise its right to set off arose only at 2:11 p.m., on July 23, 1991. Only then was D unconditionally obligated to pay IB, and only then could a setoff have been made under state law. Until payment of the letter of credit, no insufficiency existed, because IB owed D more than D owed IB.

Because IB's setoff was not entitled to protection under section 553(a), section 547 was re-established as a viable avoidance theory.[205] The transfer of debtor property in question, however, was the receipt of the wire transfer at 11:02 a.m. IB could not yet offset D's antecedent debt against the deposit of wired funds, because D's obligation to pay was still contingent on IB's payment of the letter of credit to C_1. Nevertheless, for purposes of section 547(b)(2), D owed IB an antecedent debt once the letter of credit was issued to C_1.[206] Pending the payment of a draw on the letter of credit which would permit IB to exercise its set-off right, the bank account constituted collateral for D's antecedent debt consisting of its re-

202. 11 U.S.C. § 553(b)(1) (emphasis added).

203. *See id.* § 553(a). Thus, § 553(b) appears in the laundry list of avoidance powers in § 550(a). In contrast, § 553(a)(3) does not. On the other hand, § 553 appears in § 541(a)(3), separate and apart from § 550. Such a cross reference only makes sense if § 553(a) is an avoidance theory, separate and apart from § 550. This probably proves only that not too much emphasis can be placed on the science of cross-reference in the Bankruptcy Code.

204. Bankruptcy Code § 553(b)(2) defines "insufficiency" to be "amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim." *Id.* § 553(b)(2). Until the letter of credit was paid, the amount of the claim was contingent and unknown; no setoff right existed under state law until the payment obligation arose.

205. *See id.* §§ 553(a), 547.

206. *Id.* § 547(b)(2).

imbursement obligation to pay draws, if any.[207] Hence, receiving the $31 million was like receiving a security interest in D's property. The wire transfer was not *payment*, yet it was a transfer on antecedent debt nevertheless. As such, it might be a voidable preference, because it was on antecedent debt. It was this transfer that created the possibility of a later setoff.

Both the bankruptcy court and the court of appeals in *Bergner* disagreed with the foregoing description of the avoidance theory and, as a result, fell into serious error. Both opinions identified the moment of transfer of debtor property as the moment at which D's funds were "seized."[208] Recall that D wired $31 million to IB at 11:02 a.m. A few hours later, IB wired C_1 $31,207,000. The difference of $207,000 was already present in D's bank account as a result of other deposits. Because seizure (not deposit) was considered the moment of transfer of debtor property, both the bankruptcy court and the court of appeals assumed that the voidable preference was $31,207,000 and not the lesser wire transfer of $31 million.[209]

Properly analyzed, IB should have been liable only for $31 million. This wire transfer was clearly described by section 553(a)(3), because the $31 million deposit was for the *purpose* of generating a setoff opportunity for IB.[210] The $207,000 on deposit, however, should have been separately analyzed. If it were an ordinary course deposit by D, then it would not fall under section 553(a)(3).[211] Hence, the preamble to section 553(a) would apply to give IB a voidable preference defense for $207,000.[212] This would have been apparent if the *Bergner* court had recognized that the wire transfer to the bank account—not freezing the account—was the moment of transfer. Because $31,207,000 was frozen, the court was led to conclude that the preference was $31,207,000—an overcharge of $207,000.[213] Both courts confused an enforcement step—freezing the account—with a transfer. Transfers of security interests, however, are separate and distinct from steps taken to enforce those security interests.

207. The *Bergner* court emphasizes that IB claimed a security interest in its own debt to D. P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1121 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998). The effect of this contractual provision was to assure that IB could rightfully dishonor D's checks if the agreement was in default, even if a common law right to setoff had not yet accrued, because C_1 had not yet presented the documents to render D's reimbursement obligation vested and unconditional.

208. *Id.* at 1122; *P.A. Bergner & Co.*, 187 B.R. at 973-74.

209. *P.A. Bergner & Co.*, 140 F.3d at 1117; *P.A. Bergner & Co.*, 187 B.R. at 971, 976.

210. *See* 11 U.S.C. § 553(a)(2).

211. *See* McCuskey v. National Bank (*In re* Bohlen Enters., Ltd.), 859 F.2d 561, 563 (8th Cir. 1988).

212. *See* 11 U.S.C. § 553(a).

213. *See P.A. Bergner & Co.*, 187 B.R. at 974 ("The $31,207,000 was transferred by seizure of the funds wired to the debtor, and the bank later transferred its own funds to AMC.").

Judge Wood's treatment of the timing of the transfer was particularly open to criticism. She took IB to be arguing that, at the time of the "seizure"—conceived to be the moment of transfer—IB had a security interest in the bank account.[214] This argument should have availed IB nothing because that security interest, under our analysis, was a voidable preference for which IB was liable. Judge Wood obviously feared this argument, and so she was keen to show that the security interest was unperfected. Hence, "seizure" was deemed necessary to perfect the security interest.[215]

This was clearly incorrect, however, because a security interest in a bank account is not an Article 9 transaction;[216] rather, common law governs perfection. Typically, local law states that a security interest in a bank account is valid when the secured party has "control" over the account—that is, a bank acknowledges it and agrees to follow the instructions of the secured party and not those of the debtor.[217] Obviously IB had sole dominion and control over the account because it was itself the account debtor; IB indeed had a perfected security interest to the extent relevant.[218] Indeed, the meaning of the security interest was only to establish that, after default, IB had the right to dishonor D's checks, pending IB's mature setoff rights. Judge Wood's conclusion that IB could not perfect its security interest in its own debt to D until it froze the account has no basis in law whatsoever.[219]

In *Bergner*, IB issued a separate letter of credit to C_2, an insurance provider. With regard to this second letter of credit, C_2 did not draw on it before bankruptcy. It only did so some nine months later. Nevertheless, in August 1991, IB feared that C_2 would present documents. On August 2, D's bank account had fallen to zero. Under pressure from IB, D made deposits until August 23, and by then the bank account exceeded the amount of C_2's letter of credit. On this day, IB froze D's account, just before a bankruptcy petition was filed; C_2 drew down the letter of credit by June 10, 1992.

Bankruptcy Judge Dee McGarity ruled that the transfer occurred when the account was frozen.[220] Because the transfer was deemed to have oc-

214. *P.A. Bergner & Co.*, 140 F.3d at 1121 ("Although it is somewhat unclear from the briefs, Bank One may also be arguing that it had a perfected security interest in Bergner's deposit accounts at the bank, thus preventing avoidance.").

215. *Id.*

216. *See* U.C.C. § 9-104(*l*) (1995).

217. *See e.g.*, Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548, 563 (2d Cir. 1976); Dwight L. Greene, *Deposit Accounts as Bank Loan Collateral Beyond Setoff to Perfection—The Common Law Is Alive and Well*, 39 DRAKE L. REV. 259, 295-308 (1990).

218. *See* CJL Co. v. Bank of Wallowa County (*In re* CJL Co.), 71 B.R. 261, 265 (Bankr. D. Or. 1987).

219. *P.A. Bergner & Co.*, 140 F.3d at 1121.

220. P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.) 187 B.R. 964, 973 (Bankr. E.D. Wis. 1995), *modified*, 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

curred prior to the bankruptcy petition, it was eligible to be a voidable preference.[221] This point in time is inappropriate, because merely freezing the account (as opposed to manifesting the setoff) does not constitute a transfer of debtor property.[222] Rather, the deposits which led to the improvement in position were each transfers to IB on antecedent debt. The antecedent debt existed as soon as IB issued the letter of credit to C_2—which had occurred long before. As these deposits were all within the ninety day preference period, the bank indeed had received voidable preferences.[223]

SUMMARY OF THE PRIMA FACIE CASE

A letter of credit usually implicates two transfers. First, D often transfers a security interest to IB to secure IB's reimbursement right. This security interest is rarely on antecedent debt insofar as IB is concerned (unless perfection is delayed or after-acquired property accrues after the letter of credit is issued). But where the letter of credit is issued to a beneficiary, TBC, who claims antecedent debt against the debtor, the security interest granted to IB is "for the benefit" of TBC. If created within ninety days of bankruptcy, IB is potentially liable as an initial transferee of TBC's voidable preference, even though IB issued the letter of credit and took security simultaneously.

The second transfer is issuance of the letter of credit itself. If this letter of credit is issued within the preference period on antecedent debt, TBC will have liability.

Meanwhile, just as the issuance of the letter of credit constitutes a transfer of debtor property to TBC, likewise the issuance creates "antecedent debt" between IB and D. Any transfer received by IB after the issuance of the letter of credit is a transfer on antecedent debt and hence potentially voidable. Such transfer, however, does not benefit TBC because the transfer to IB was not a condition precedent to issuance of the letter of credit.

IB, then, faces *Deprizio* liability when it receives a security interest at the same time it issues a letter of credit to TBC on TBC's antecedent debt. Defenses, however, will mitigate the situation for IB, though some surprising risks nevertheless will remain for a bank that honors the letter of credit after it has notice of the debtor's bankruptcy.

221. *Id.* at 977. Preferences involve transfers *before* the bankruptcy petition. 11 U.S.C. § 547(b)(4) (1994).

222. *See supra* text accompanying notes 191-203.

223. Judge McGarity also ruled that IB's setoff could be avoided under § 553(b). *P.A. Bergner & Co.*, 187 B.R. at 982-83. But this required the manifestation of a setoff prior to bankruptcy. Heckathorn Constr. Co. v. Bass Mechanical Contractors, Inc. (*In re* Bass Mechanical Contractors, Inc.), 88 B.R. 201, 203 (Bankr. W.D. Ark. 1988). Merely freezing the account is not a setoff. Citizens Bank v. Strumpf, 516 U.S. 16, 18-19 (1995).

DEFENSES

The above sections steered two transfers—the transfer by D of a security interest to IB and the beneficiary's rights under the letter of credit to TBC—through the shallows and shoals of the bankruptcy trustee's prima facie case. The result undoubtedly seemed over-inclusive. Even IB's security interest was a prima facie voidable preference if granted within ninety days of bankruptcy on TBC's antecedent debt. Defenses, however, may be available to absolve IB and TBC, the beneficiary of a letter of credit.

By far the most significant of these defenses in letter of credit cases is the one provided in section 547(c)(1), which states that the trustee may not avoid a transfer "to the extent that such transfer was—(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange."[224] Key to the proper analysis of the (c)(1) defense is the passive structure of section 547(c)(1)(A).[225] This subsection requires that the debtor *receive* new value, but it does not require that the specific defendant be the giver. Only intentionality and contemporaneity are required.

THE BANK'S SECURITY INTEREST CONTEMPORANEOUS WITH ISSUANCE OF THE LETTER OF CREDIT

In a letter of credit case, in which IB's security interest is created within the preference period to secure reimbursement of a letter of credit issued to support TBC's antecedent debt, IB's security interest is prima facie voidable on *Deprizio* grounds, even though it was contemporaneous with the issuance of IB's letter of credit. Nevertheless, as we explained earlier, IB should win protection under section 547(c)(1).[226] Because this is so, neither IB nor TBC should be liable for any voidable preference related to the security interest itself.

THE BANK'S SECURITY INTEREST ON ITS OWN ANTECEDENT DEBT

The (c)(1) defense might also help IB save its security interest when D grants the security interest to IB *after* IB issues the letter of credit to a beneficiary (whether bad or good). In *Pine Top Insurance Co. v. Bank of America National Trust & Savings Ass'n*,[227] IB issued a letter of credit to a valid beneficiary, intending to obtain a security agreement from D. It did not obtain the security agreement until three weeks, or perhaps seven weeks, later. As D was an insurance company, D was ineligible to file for bankruptcy. Illi-

224. 11 U.S.C. § 547(c)(1).
225. *Id.* § 547(c)(1)(A).
226. *See supra* text accompanying notes 125-29.
227. 969 F.2d 321 (7th Cir. 1992).

nois receivership law, as it applies to insurance companies, has a preference law, which resembles old section 60 of the Bankruptcy Act.[228] Section 60 had no express provisions like section 547(c)(1).[229] The court nevertheless proceeded as if section 547(c)(1) applied. It did so under the guise of the "well-established exception known as the 'substantially contemporaneous exchange' rule."[230] This exception modified the prima facie case under Illinois preference law and did not technically constitute a defense, as it does under the Code.

The court in *Pine Top* ruled that the parties intended a contemporaneous exchange of issuance of the letter of credit for present collateral.[231] Furthermore, the gap between the issuance of the letter of credit and the grant of security was not deemed so great that the grant was not "substantially" contemporaneous with the issuance of the letter of credit.[232] This case, if it had occurred under the Bankruptcy Code, was therefore appropriate for the (c)(1) defense, provided one agrees that three (or, perhaps, seven) weeks was "substantially contemporaneous," a finding of fact committed to the discretion of the trial judge.

Pine Top involved a gap between issuance of the letter of credit and attachment of a security interest. Security interests may issue on account of antecedent debt when a gap exists between attachment and perfection. Thus, if a bank receives an unperfected security interest contemporaneously with the issuance of the letter of credit, and if IB perfects more than ten days later, section 547(e)(2)(B) deems that the transfer occurred at the time of perfection.[233] Or, if IB never perfects, section 547(e)(2)(C) deems the transfer to occur just before the bankruptcy petition.[234] These rules transform contemporaneous exchanges into antecedent debt, and they constitute a traditional means by which the Bankruptcy Code punishes the supposed evil of the secret lien.[235]

228. *Id.* at 323-24, 324 n.2; *see* Bankruptcy Act § 60 (1898) (repealed 1979).

229. *See* Bankruptcy Act § 60; 11 U.S.C. § 547(c)(1).

230. *Pine Top Ins. Co.*, 969 F.2d at 324.

231. *Id.* at 325.

232. *Id.* at 326-27.

233. 11 U.S.C. § 547(e)(2)(B).

234. *Id.* § 547(e)(2)(C). This rule has been added because, without it, an unperfected security interest is not even a transfer. Only transfers *before bankruptcy* are voidable preferences and so, without Code § 547(e)(2)(C), an unperfected security interest could never be a voidable preference. *See* Carlson, *supra* note 17, at 222.

235. Congress began to manipulate the timing of security interests because unsecured creditors took security on antecedent debt and then kept the liens secret by not recording them until just before the bankruptcy. This was done in the hope that 120 days (the preference period under the Bankruptcy Act) would pass, thereby immunizing the security interest from voidability. By declaring that the security interest would be deemed transferred when it was perfected, Congress hoped to defeat this practice. *See* C. Robert Morris, Jr., *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 MINN. L. REV. 737, 740-41 (1970). So conceived, Congress aimed at secret liens that secured antecedent debt. As it currently stands, voidable preference law also targets unperfected security interests that were contemporaneous exchanges when initially created.

Section 547(c)(1)[236] might allow IB to prevail even if section 547(e)(2)(B)[237] or section 547(e)(2)(C)[238] applied to postdate the transfer. Thus, if the parties intended that a security interest to IB be contemporaneous with the issuance of a letter of credit, and if perfection occurs within three weeks of attachment—declared by the *Pine Top* court to be substantially contemporaneous—then, even though section 547(e)(2)(B) changes this transfer into one on IB's antecedent debt, a (c)(1) defense should rightly save IB.

Many courts, however, refuse to permit the (c)(1) defense to save the grace period mistakes of secured parties. Some courts protest that the legislative history[239] of section 547(c)(1) indicates only an intent to protect bank checks that might take some days to clear after a debtor buys goods by check.[240] Courts also have excluded secured parties from section 547(c)(1) because to do so would read section 547(e)(2)(A)[241] or section 547(c)(3)[242] out of existence.[243]

Neither point is convincing. First, the legislative history may refer only to checks, but the statute is broadly written[244] and has been applied generally to hundreds of circumstances that do not involve delays in payment caused by checks.[245] Second, the statutes are hardly superfluous if section 547(c)(1) protects delayed perfection. It is easy to show that section 547(e)(2)(A) is not read out of the Bankruptcy Code when secured parties are given a defense under section 547(c)(1). The grace period under section 547(e)(2)(A) could be viewed as a "safe harbor" to guarantee that a contemporaneous exchange is not changed into a transfer on antecedent debt. Meanwhile, when the grace period is not met, section 547(c)(1) requires that IB actually prove that the transfer was substantially contemporaneous with the extension of new value by the secured party. Only if delayed

236. 11 U.S.C. § 547(c)(1).

237. *Id.* § 547(e)(2)(B).

238. *Id.* § 547(e)(2)(C).

239. S. REP. NO. 95-989, at 88 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874 (citing U.C.C. § 3-503 (defining ordinary course of business as 30 days)).

240. *See, e.g.*, Gower v. Ford Motor Credit Co. (*In re* Davis), 734 F.2d 604, 606 (11th Cir. 1984); Ray v. Security Mut. Fin. Corp. (*In re* Arnett), 731 F.2d 358, 361 (6th Cir. 1984).

241. *See, e.g.*, *Arnett*, 731 F.2d at 362-63; Valley Bank v. Vance (*In re* Vance), 721 F.2d 259, 261 (9th Cir. 1983).

242. *See, e.g.*, Wachovia Bank & Trust Co. v. Bringle (*In re* Holder), 892 F.2d 29, 30 (4th Cir. 1989) (per curiam); Union Bank & Trust Co. v. Baker (*In re* Tressler), 771 F.2d 791, 794 (3d Cir. 1985); *Davis*, 734 F.2d at 607; *Vance*, 721 F.2d at 261; Westenhoefer v. PNC Bank (*In re* Smallwood), 204 B.R. 519, 520 (Bankr. E.D. Ky. 1997).

243. One leading case states that § 547(c)(1) applies in this context, but "[t]he applicability of § 547(c)(1) . . . is thus limited to ten days." *Arnett*, 731 F.2d at 364. This is the same as saying § 547(c)(1) does not apply at all, as the 10 days are already supplied by § 547(e)(2)(A).

244. *See* Belisle v. Plunkett, 877 F.2d 512, 516 (7th Cir. 1989) (stating "statutes often create rules that reach beyond the immediate concerns that spawned them").

245. Carlson, *supra* note 103, at 280-98.

perfection is not substantially contemporaneous would IB's security interest be vulnerable to avoidance.[246]

The (c)(1) defense should be applied to preserve IB's security interest from an unsubstantial gap, whether the gap is between issuance of the letter of credit and attachment[247] or whether the gap is between attachment and perfection. Hostility to secret liens is, in the main, misguided.[248] Section 547(c)(1) should be used to save secured parties whose lateness in perfection was substantially contemporaneous enough to perfection that no one was harmed.[249] Case law, however, is hostile when the gap is between attachment and perfection.

OTHER TRANSFERS TO THE BANK

If, within ninety days of bankruptcy, a bank receives a security interest contemporaneously with the issuance of a letter of credit, IB's security interest is a prima facie voidable preference if TBC has antecedent debt. Yet, both IB and TBC have a (c)(1) defense based on that security interest.

This defense depends on substantial contemporaneity between the transfer of the security interest and the issuance of the letter of credit. If the issuance of the letter of credit precedes the security interest, IB has no defense. The trustee has the right to recover the collateral itself, or, if the court permits, its value from IB.[250] The trustee probably may not recover the value of this security interest from TBC. TBC did not benefit from this security interest because creation of the security interest was not a condition precedent to issuance of the letter of credit. TBC obtained the letter of credit regardless of this security interest transferred on IB's antecedent debt.[251]

If IB has received a transfer after a letter of credit has been issued, IB would need to find some other new value that D received contemporaneously with the transfer D made to IB. The next several sections describe the possibilities.

246. The need to prevent § 547(c)(3)'s superfluity is also unconvincing, as this grace period protects security interests *not* necessarily intended to be contemporaneous exchanges—that is, enabling loans where the loan is made first and the purchase money collateral is bought later. Nathan Eisler, *Beyond the Grace Period: Security Interests as Preference Exceptions Under Section 547 of the Bankruptcy Code*, 1984 ANN. SURVEY BANKR. L. 63, 69. As § 547(c)(1) covers transfers intended to be contemporaneous, § 547(c)(3) clearly remains necessary for purchase money transactions not intended to be contemporaneous.

247. *See, e.g.*, Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n, 969 F.2d 321, 326 n.5 (7th Cir. 1992).

248. *See* Jeanne L. Schroeder, *Some Realism About Legal Surrealism*, 37 WM. & MARY L. REV. 455, 461-64 (1996).

249. Carlson, *supra* note 103, at 295.

250. 11 U.S.C. § 550(a) (1994).

251. *See supra* text accompanying notes 135-37.

Earmarking and Discretionary Advances

In *P.A. Bergner & Co. v. Bank One (In re P.A. Bergner & Co.)*,[252] IB received a wire transfer from SB to fund IB's payment of a letter of credit to C_1 (a legitimate beneficiary). The wire transfer was on IB's antecedent debt and hence a prima facie voidable preference to IB.[253] Nevertheless, if an unsecured creditor provided a new credit commitment and financed the wire, IB would have had an earmarking defense, which we have identified as falling under section 547(c)(1).[254]

In *Bergner*, IB knew that C_1 would soon draw on a letter of credit. IB was unsecured for this exposure. D drew on SB's facility and caused $31 million to be wired to IB a few hours before IB wired funds to C_1.

If SB's funds were proceeds of an unsecured loan to D made pursuant to an uncommitted line of credit and transferred contemporaneously with the wire transfer, then IB had a section 547(c)(1) "earmarking" defense.[255] That is, SB would have provided new credit to D. D and IB would have intended this transfer to be contemporaneous with D's transfer to IB. Indeed, assuming contemporaneity existed, the new credit supplied by SB *was* the transfer of debtor property to IB. Accordingly, the $31 million wire to IB might have been shielded by section 547(c)(1).[256]

These $31 million in funds, however, were not immediately applied by IB to its claim against D. Indeed, IB's claim was still contingent on IB paying the draw. IB could not then have applied these funds to any unconditionally owed antecedent debt. A review of earmarking cases yields the impression that "debtor control" of transferred property kills the earmarking defense for a preferred creditor.[257] Thus, if SB had made a loan to D for general purposes, and if D used its discretion to divert the funds to IB, IB could have no earmarking defense, because D "controlled" the funds for a period between the loan and the transfer for IB. In section 547(c)(1) parlance, the loan by SB would no longer be contemporaneous with the transfer of funds by D to IB.[258] Could it be said in *Bergner* that D

252. 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

253. *See supra* text accompanying notes 171-75.

254. *See supra* text accompanying notes 114-30.

255. *See id.*

256. The new value need not be currency, nor is it necessary that D "pay" IB in the sense of extinguishing antecedent debt. The supply of some other commodity might do, where IB is given a mere security interest in the commodity. Thus, in *Boldt v. Alpha Beta Co. (In re Price Chopper Supermarkets, Inc.)*, 40 B.R. 816, 820 (Bankr. S.D. Cal. 1984), a shareholder of D provided shares of stock to D, so that D could pledge it to IB on IB's antecedent debt. Judge Louise DeCarl Adler properly ruled that IB was entitled to the earmarking defense. *Id.*; *accord* Bakst v. A.M.I. Builders Corp. (*In re* Ameritech Homes, Inc.), 88 B.R. 432, 433 (Bankr. S.D. Fla. 1988) (holding that TBC could assert defense because IB received collateral from shareholder).

257. *See, e.g.*, McLemore v. Third Nat'l Bank (*In re* Montgomery), 983 F.2d 1389, 1395 (6th Cir. 1993).

258. *See* 11 U.S.C. § 547(c)(1) (1994).

"controlled" the $31 million now credited by IB to D's account? Could this two hours of "control" be fatal to an earmarking defense?

The answer is that D never had control of these funds. Even though IB could not manifest its setoff for two hours, IB had no obligation to honor D's checks. IB's "security interest" on these funds meant that the funds were effectively frozen.[259] Before the time that IB had a present setoff right, IB could dishonor all checks and be guilty of no wrong to D. This power of IB shows that IB had total mastery over the funds until the setoff accrued and was declared.[260]

As to the ultimate merits of the defense, still assuming contemporaneity, if SB had been fully secured, the (c)(1) defense would not have been available. In such a case, D would have transferred a security interest to SB. This security interest was a voidable preference for the benefit of IB, unless SB had a (c)(1) defense. Its advance of funds to IB was "new value" given to D. As this was *ex hypothesi* contemporaneous with SB's security interest, SB had a (c)(1) defense. But section 547(c)(1) protects voidable preferences only "to the extent" new value is given.[261] This implies that if new value was used up by SB, IB could not have availed itself of the same new value a second time.[262] Hence, IB would be left without a defense, to the extent SB obtained a security interest when it wired funds to IB and used up the new value defense before IB could do so.

The *Bergner* court describes SB as "undersecured."[263] Still continuing to assume that the SB advance was discretionary at the time it was made, undersecurity requires the mixture of the above two views. Suppose, for example, that SB had $10 million in collateral to secure the discretionary advance of $31 million. In such a case, the new value of $31 million entirely defends the contemporaneous $10 million security interest given to SB. When a secured creditor gives a discretionary advance, a security interest is instantly created whenever the advance is the last element of Article 9 attachment.[264] Such a conclusion presupposes that an earlier security agreement designated assets as collateral for any advance SB chose to make.

259. *See supra* text accompanying notes 189-91.

260. Even without D's grant of the "security interest," IB had power to delay payment of any check until its midnight deadline. U.C.C. § 4-301(a) (1995). If IB is presented with a check, honors a letter of credit, declares a setoff and dishonors the presented check, IB has done no wrong to D. D, therefore, had no "control" until IB's midnight deadline. *Cf. In re* McLean Indus., Inc., 90 B.R. 614, 619 (Bankr. S.D.N.Y. 1988) (holding that bank contractually waived its setoff right and hence would have had the obligation to honor checks).

261. 11 U.S.C. § 547(c)(1).

262. As seen earlier, the defense would have to be allocated between SB (the new lender) and IB (in this context, the "bad creditor"). Reasons why allocation must be made to the new lender were discussed above. *See supra* text accompanying notes 125-28.

263. P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1118 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1995).

264. *See* U.C.C. § 9-303(1) (1995).

Only $10 million of the new value given would have been needed by SB to preserve its security interest. Another $21 million of new value remains. This new value constitutes genuine earmarking, and it is available to defend the prima facie voidable preference of $31 million that IB received. Hence, undersecured discretionary advances by a refinancing creditor partly supplies and partly does not supply a (c)(1) defense for IB.

Earmarking and Committed Advances

The earmarking defense which we have located in Code section 547(c)(1) exists only if the advance by the refinancing lender was a discretionary advance. In such a case, the advance is contemporaneous with the transfer received by TBC who is validly paid by means of the refinancing.

In *Bergner*, however, the draw from SB appears to have been made pursuant to commitment.[265] Under U.C.C. section 1-201(44), commitments to lend are deemed to be value.[266] Hence, if SB had a security interest years before the wire transfer to IB, the new value—the commitment—was also given years before. It was not contemporaneous with the wire transfer to IB. Hence, IB could not show contemporaneity of new value with D's transfer to IB. The defense fails. IB is truly TBC—a bad creditor.

Under the assumption that the SB advance was pursuant to commitment, the wire transfer to IB should be seen as preferential. In effect, D's right to draw under the SB facility is debtor property—D's general intangible right against SB.[267] This property should not have been diverted to an unsecured creditor such as IB on the eve of bankruptcy. Rather, D should have used this asset for the benefit of all creditors equally—perhaps by acquiring inventory or something else of value to D's estate. Diverting the funds to IB violates both the letter and spirit of preference law.[268]

It may be objected that SB's commitment to lend was heavily conditioned. Hence, until the advance was actually made, both D and IB faced uncertainty whether the advance *would* be made. It may be proffered that, in light of such uncertainty, the actual advance under the commitment was contemporaneous with the wire transfer.

265. *Id.* § 9-105(1)(k) ("An advance is made 'pursuant to commitment' if the secured party has bound himself to make it, whether or not a subsequent event of default or other event not within his control has relieved or may relieve him from his obligation . . . .").

266. *Id.* § 1-201(44).

267. On the status of loan commitments as D's general intangible property, see *supra* text accompanying notes 107-09.

268. Judge McGarity made a similar point, but with regard to Bank One. She thought that Bank One's letter of credit, once issued, constituted an asset to the estate, which should have been used for the equal benefit of all creditors. P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 187 B.R. 964, 974 (Bankr. E.D. Wis. 1995), *modified*, 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998). Payment of Bank One was therefore seen as diminishing the debtor's estate. Likewise, the Swiss commitment was property of the estate and should have been used for the common good of all creditors—not diverted to Bank One.

We believe this claim merely confuses the idea of contingent property with no property. It is true that conditions subsequent adhered to D's right to draw down SB credit. Indeed, soon after the $31 million wire, SB, announcing a "material adverse change" of D's financial condition, refused to advance any new funds.[269] There is no reason, however, why a debtor could not own property on a condition subsequent. It is still debtor property until the contingency terminates the debtor's interest. In *Bergner*, the $31 million wire transfer constituted a realization of pre-existing debtor property before any condition subsequent occurred. Hence, debtor property was newly transferred to IB, but value was not *newly given*. Rather, new value was given to D years before when SB committed to lend.

In short, we suggest that an earmarking defense depends on a *discretionary advance* being made as part of an unsecured refinancing. When refinancing occurs pursuant to a pre-existing commitment on the part of the refinancing creditor, earmarking never applies. This is the strong implication of locating the earmarking defense under Code section 547(c)(1).[270]

Earmarking was raised before Judge McGarity and was dispensed with on these grounds. According to Judge McGarity's dismissal of this defense:

> The "earmarking doctrine," developed to interpret whether an interest of the debtor in property has been transferred, clearly does not apply to these facts. Earmarking occurs only when a new creditor advances funds, and the parties intend that those funds be used to pay an antecedent creditor. Payment of the old creditor is a condition for obtaining the new credit. This type of transfer results only in the substitution of creditors, and there is no diminution in the debtor's property. Swiss Bank loaned the funds with no agreement as to their

269. *P.A. Bergner & Co.*, 140 F.3d at 1116.

270. 11 U.S.C. § 547(c)(1) (1994); *accord In re* EDC, Inc., 930 F.2d 1275, 1282 (7th Cir. 1991) (where guarantor already owed obligee, payment under guaranty could not constitute new value to support transfer to guarantor). In *Cambridge Meridian Group, Inc. v. Connecticut National Bank (In re Erin Food Services, Inc.)*, 117 B.R. 21 (Bankr. D. Mass. 1990), an insider guaranteed undersecured creditors, who also offered unsecured revolving credit. The debtor drew down unsecured credit to pay interest on the secured claim. Judge Harold Lavien ruled that the voidable preference liability of the undersecured parties was canceled by a (c)(1) defense. *Id.* at 30-31. That is, the revolving credit was substantially contemporaneous with the payment of interest. Meanwhile, the insiders could rely on obligees' (c)(1) defense to prevent their own liability.

The trouble with this holding is that the payment of interest to the undersecured creditors was not contemporaneous with the giving of new value (by the same creditors). The new value was "pursuant to commitment" and so was not available as (c)(1) defense material.

Later, Judge Lavien seems to have changed his mind and ruled that the undersecured parties were liable after all. From this unreported *changement de coeur* the undersecured parties appealed. In *Travelers Insurance Co. v. Cambridge Meridian Group, Inc. (In re Erin Food Services, Inc.)*, 980 F.2d 792 (1st Cir. 1992), Judge Conrad Cyr found that no benefit to insiders existed, thereby defeating any prima facie case and obviating any need to consider the status of any defense under § 547(c). *Id.* at 802-03.

> use to pay [C_1]; in fact, Swiss Bank's representative testified at his deposition that Swiss Bank had no right under the loan agreement to direct how [D] used its borrowed funds. Therefore, the earmarking doctrine does not apply.[271]

There is much to disagree with in this account. First, although earmarking traditionally has been thought to establish that an unsecured loan from a refinancing creditor is not debtor property, this claim had been shown to be illogical. Rather, all loans drawn by a debtor are debtor property—including letters of credit. Earmarking must be viewed as an example of the (c)(1) defense. Second, diversion of funds to C_1 in *Bergner* is irrelevant. Diversion to IB is what should count for earmarking. Nevertheless, in the above passage, Judge McGarity seems to grasp the fact that the SB commitment to D was not contemporaneous with D's decision to use the commitment to wire funds to IB. This explains her emphasis on the lack of control by SB as to how the loan commitment would be used.[272] Thus, *Bergner* could be seen, in the above passage, as limiting the earmarking defense to a discretionary advance made contemporaneously with the payment of the loan proceeds to the refinanced creditor.

Disposition of the Draw

In *Bergner*, IB received a wire transfer at 11:02 a.m. and paid a beneficiary, C_1, at 2:11 p.m. The wire transfer was nevertheless a transfer on IB's antecedent debt, even though D did not have to pay IB at 11:02 p.m. Per earlier discussion, "antecedent debt" does not mean absolute lack of contingency in D's obligation to pay, provided real value was actually extended.[273] IB, however, tried to argue that C_1's draw of the letter of credit constituted new value given back to D. In effect, C_1 obtained the 2:11 p.m. draw and held it in trust for D. When C_1 shipped future goods to D, it debited these trust funds for the price. Hence, IB maintained, the funds never really left the debtor's estate. The estate was not depleted. Disposition of the draw was therefore contemporaneous with payment of the letter of credit, according to IB.

Could IB claim that C_1 gave D new value contemporaneously (or substantially so) with the wire transfer from SB? The *Bergner* court thought not,[274] and we agree. Any reliance on the fate of the draw flounders on the separate requirement that the contemporaneous exchange be *intended.* IB had an obligation directly to C_1 to pay if documents were presented. No matter what D and C_1 may have intended, IB was helpless. Even if SB never wired $31 million, IB still had to pay C_1. Insofar as C_1 gave the

271. *P.A. Bergner & Co.*, 187 B.R. at 974.
272. *Id.* at 975.
273. *See supra* notes 147-63 and accompanying text.
274. *P.A. Bergner & Co.*, 187 B.R. at 979.

value back to D, this was not the intended result but purely a dumb accident, insofar as IB was concerned. C_1 could easily have applied these proceeds to an antecedent debt without affecting the structure of the deal. For this reason, the return of the draw to D could not sustain a (c)(1) defense to IB, because the contemporaneous exchange was not *intended*.[275]

Such a conclusion coheres with another holding of Judge McGarity in *Bergner* with regard to the SB draw. In order to defeat IB's earmarking defense, Judge McGarity ruled that SB had no power to direct the funds from the commitment.[276] Accordingly, the fact that the funds ended up under the control of IB was a matter of coincidence. It was not intended. A better way of putting this is that SB had given new value to D at the time of the commitment. The draw under the commitment was not contemporaneous with the giving of new value. This holding is identical to the conclusion that the fate of a draw under a letter of credit cannot be the stuff of the IB's (c)(1) defense.

A comparison might be made with *Gulf Oil Corp. v. Fuel Oil Supply & Terminaling, Inc.* (*In re Fuel Oil Supply & Terminaling, Inc.*),[277] where IB issued letters of credit to D's supplier, TBC, in contemporaneous exchange for a security interest in collateral, ample enough to keep IB fully secured. The supplier sent gasoline to D and thereby became an unsecured creditor of D. Instead of calling in the letter of credit, the supplier accepted payment directly from D. The supplier received a prima facie voidable preference under section 547(b),[278] but it had a full defense under section 547(c)(1).[279] Every dollar the debtor paid released a dollar of collateral earlier pledged to the sureties.[280]

275. P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1120 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998) ("Bank One had no legally recognizable interest in what [C_1] did with the money or how its actions related to its dealings with [D]."). *P.A. Bergner & Co.*, 187 B.R. at 979. Consider also the second letter of credit at stake in the *Bergner* case, issued to C_2 (Liberty Mutual Insurance Co.). The draw from this letter of credit was used to pay workers' compensation claims, for which C_2 was liable. These workers were employees of an operating subsidiary of D and so were not creditors of D. (Conversation with David C. Bryan, counsel for the debtor.) In effect, the draw from the letter of credit was used to pay debts of a subsidiary. Such transfers would not be fraudulent conveyances, because they would make D's equity shares in the subsidiary more valuable.

276. *P.A. Bergner & Co.*, 187 B.R. at 975.

277. 837 F.2d 224 (5th Cir. 1988).

278. 11 U.S.C. § 547(b) (1994).

279. *Id.* § 547(c)(1).

280. Such a view, however, must be reconciled with § 547(a)(2)'s definition of "new value." According to that definition, new value includes "release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, *including proceeds of such property*." 11 U.S.C. § 547(a)(2) (emphasis added). In *Fuel Oil Supply*, the original security interest was not released. *Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d at 231. A security interest is, by definition, the power to sell a thing in order to raise cash for debt. By no means was the *power* to sell in any way reduced. What was released was the prospective *proceeds* of property encumbered by the valid lien. The italicized portion of § 547(a)(2) should adequately ground the result in *Fuel Oil Supply* in statutory language.

Thus, payment to the supplier in *Fuel Oil Supply* generated a (c)(1) defense for the supplier, because the collateral pledged by D to IB was disencumbered dollar for dollar when D paid the supplier.[281] As payment to the supplier had this natural consequence, we can say that D and the supplier intended the result that was certain to follow.[282] The same, however, cannot be said when D pays IB. Any return of value by C_1 to D in *Bergner* was not the natural consequence of paying IB. Rather, such returns are utterly coincidental and hence not intended.[283]

Direct payment to a supplier secured by a pre-existing letter of credit when IB is undersecured accordingly gives the supplier a partial defense.[284] To the extent payment to the supplier does not release collateral, the supplier cannot defend. To the extent collateral is disencumbered, the defense exists.[285] What is sometimes overlooked, however, is that the first payments to the supplier—the ones that are not defended—are transfers *to* the supplier, but for the *benefit* of IB. A bankruptcy trustee, therefore, may have the option of pursuing IB for the value of the voidable payments made to the supplier.[286]

281. *Accord* Gilchrist Mach. Co. v. Ross (*In re* Gilchrist Mach. Co.), 108 B.R. 124 (Bankr. S.D. Miss. 1989). *But see* Erman v. Armco, Inc. (*In re* Formed Tubes, Inc.), 41 B.R. 819, 822 (Bankr. E.D. Mich. 1984) (TBC held liable even though IB was fully secured.). For a case entirely overlooking this defense, see *Krafsur v. Scurlock Permian Corp.* (*In re El Paso Refinery, L.P.*), 178 B.R. 426 (Bankr. W.D. Tex. 1995) *rev'd on other grounds*, 171 F.3d 249 (5th Cir. 1999). In this case, a purchase money lender (C) received cash proceeds in payment of antecedent debt. Surrenders of cash proceeds should never be preferential, and so the case should have failed on prima facie grounds (as the Fifth Circuit would later rule). Nevertheless, TBC promised to share 45% of proceeds with IB. Judge Leif Clark ruled that receipt by TBC of this 45% was the same as the receipt of unencumbered dollars—an erroneous conclusion. If D gave A's proceeds to IB, D gave property worth zero to D. Such payment could never flunk the hypothetical liquidation test of § 547(b)(5). *See El Paso Refinery, L.P.*, 171 F.3d at 258; *see also* 11 U.S.C. § 547(b)(5).

Nevertheless, assuming the payments were preferential, TBC went on to claim that new oil supplied to D constituted the give-back of new value under § 547(c)(4). *See El Paso Refinery, L.P.*, 171 F.3d at 258. Judge Clark properly rejected this defense, because new shipment of oil permitted TBC to draw on a fully secured letter of credit issued by IB. *El Paso Refinery, L.P.*, 178 B.R. at 442-43. What Judge Clark overlooked was the (c)(1) defense. Every wire transfer in the case to TBC reduced D's reimbursement obligation to C. Under *Fuel Oil Supply*, all these payments should have been defended.

282. RESTATEMENT (SECOND) TORTS § 8A (1964) (stating "the actor desires to cause consequences of his act, or that he believes that consequences are substantially certain to result from it").

283. *Accord* P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1121 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

284. *See* Committee of Creditors Holding Unsecured Claims v. Koch Oil Co. (*In re* Powerine Oil Co.), 59 F.3d 969, 973 (9th Cir. 1995) (where bank was undersecured, payment of deficit to TBC generated no defense, but extra payments released security interests and so were protected).

285. *Id.*

286. *See* Baxter, *supra* note 7, at 86-87 (pointing out IB's liability under these circumstances).

Lapse of the Letter of Credit

The issuance of the letter of credit is the time at which IB has antecedent debt against D. Any transfer to IB thereafter potentially constitutes a voidable preference. Issuance is also the time TBC has received debtor property.

A letter of credit often lapses by its terms at a stated time. If so, IB's obligation to the beneficiary terminates. IB's claim against D for reimbursement never becomes vested. It ceases to exist.

A certain paradox with regard to letters of credit that lapse may be noted. As a matter of state law, IB is indifferent whether it is paid or whether the letter of credit lapses by its own terms. In either case, IB's position is neutralized. Nevertheless, as a matter of federal law, if D pays IB after the letter of credit is issued, the payment is prima facie preferential and so is recoverable by D's bankruptcy trustee.[287] Yet, if the letter of credit lapses without a draw, IB is just as well off as if it had been paid by D. Why should the payment be a voidable preference (resulting in liability absent a defense) when lapse is considered benign?

Statutorily, the answer is that D has transferred no property to IB when IB's letter of credit lapses.[288] Economically, the answer can be grounded in the comparative impact on the debtor's estate. If D pays IB on antecedent debt, IB's claim against D disappears. The payment is a voidable preference, and IB must reimburse the bankruptcy estate. Lapse, however, involves no transfer to the issuing bank. In a documentary context, lapse usually means that D has lost goods to be shipped by TBC, but D saves the price and perhaps has a breach of contract action for failure to consummate the sales transaction. In a standby context, lapse means only that, instead of IB's claim against the bankruptcy estate, the estate shall have to entertain TBC's claim instead. If IB was secured and TBC was unsecured, the effect of lapse is beneficial to the debtor's estate. If both were unsecured, the effect is neutral. In both cases, the effect to D's estate was either beneficial or neutral, when lapse occurs.

If lapse is treated benignly in bankruptcy law, and if the issuance of a letter of credit is deemed to be new credit given to D, the possibility might arise that IB, D, and TBC might contrive to let a standby letter of credit lapse. D might then put funds in IB and issue a new letter of credit to TBC. If so, then the new letter of credit might be viewed as new credit to D in exchange for payment by D.

This possibility is precluded by the definition of new value. New value is variously defined in Code section 547(a)(2), but, in the end, that section banishes from its domain "an obligation substituted for an existing obli-

287. This is true simply because issuance of the letter of credit is the moment at which a debt arises and, accordingly, any subsequent payment on that debt is a payment made in respect of antecedent debt—a prima facie preference.

288. It is analogous to the expiration of an option.

gation."[289] This is precisely what the issuing bank does when the old letter of credit lapses and a new one is issued. First, IB substitutes an obligation to TBC by issuing TBC a new letter of credit.[290] Next, D substitutes its original reimbursement obligation with a new reimbursement obligation. IB does not give "new" value because IB has only given a substituted claim against D.[291] TBC does not receive debtor property a second time because TBC's rights against IB are independent of D, and IB has merely rolled over IB's obligation to TBC. Thus, if IB receives a transfer with regard to the second letter of credit, it is a naked preference with no defense under section 547(c)(1).[292]

The word "substituted," however, is important. The above discussion assumes that the parties intended one letter of credit to be replaced by another. If, however, the letters of credit are genuinely unconnected in the minds of D and IB, then each letter of credit is indeed new value. The second letter of credit would not then be D's obligation to reimburse substituted for another. For example, if IB's first letter of credit lapses, IB's relation to TBC has terminated. A second, different letter of credit not intended to substitute for the first might then be secured. If so, a security interest taken by IB could not be challenged as a voidable preference.

One commentator presents such an example.[293] Suppose TBC has the right to present documents on a standby letter of credit with regard to promissory notes issued to TBC by D. The notes become due and D pays. The letter of credit lapses. TBC agrees to lend again on a new note. IB agrees to issue a new letter of credit to TBC, but only if D puts TBC into funds in advance of the letter of credit. D puts IB into funds and soon files for bankruptcy.

If IB was under no obligation to extend the second letter of credit, IB has provided new value contemporaneously with D's transfers to IB. Accordingly, IB is entitled to the (c)(1) defense.[294] On the other hand, if IB was contractually required to issue the second letter—as under the *Bergner* case—then IB engages in mere substitution and has given no value.[295]

289. 11 U.S.C. § 547(a)(2) (1994).

290. *See* P.A. Bergner & Co. v. Bank One (*In re* P.A. Bergner & Co.), 187 B.R. 964, 981-82 (Bankr. E.D. Wis. 1995), *modified*, 140 F.3d 1111 (7th Cir.), *cert. denied*, 119 S. Ct. 409 (1998).

291. *See id.* at 982.

292. *See* Security Servs., Inc. v. National Union Fire Ins. Co. (*In re* Security Servs., Inc.), 132 B.R. 411, 416-17 (Bankr. W.D. Mo. 1991) (holding that TBC did not benefit from IB's security interest under these circumstances). *Security Services* can be taken to imply that, because TBC did not benefit from the security interest issued to IB for the renewed letter of credit, IB must have taken the security interest on antecedent debt and, therefore, was liable as initial transferee.

293. *See* Robert M. Saunders, *Preference Avoidance and Letter of Credit Supported Debt: The Bank's Reimbursement Risk in its Customer's Bankruptcy*, 102 BANKING L.J. 240, 246-48 (1985).

294. *See id.*

295. *See id.* at 252-53. In *P.A. Bergner & Co.*, IB tendered a second letter of credit to C_2 on condition that C_2 not draw on the first letter of credit, which was about to lapse. *P.A. Bergner & Co.*, 187 B.R. at 981-82.

VOIDABILITY AND ITS CONSEQUENCES

The above discussion has shown that banks issuing letters of credit have no liability for voidable preference provided they take transfers contemporaneously with the issuance of the letter of credit. The beneficiary of the credit, however, may have liability if it received a letter of credit on antecedent debt within the preference period. When TBC is held liable and IB is held harmless, pursuant to the aforementioned theory, IB may nevertheless face some risk, depending on the scope given to the concept of voidability and its relationship to the bankruptcy estate on the date of filing the petition.

THE TRUSTEE'S FUTURE INTEREST IN VOIDABLY CONVEYED PROPERTY

To understand the nature of IB's risk, an explanation of the theory that underlies the very notion of voidability is needed. The explanation begins with an analysis of ordinary payment of antecedent debt by the tender of a dollar. Thereafter, the principles developed from this demonstration will be applied to the more complex environment of letters of credit.

Suppose D pays an unencumbered dollar to TBC on antecedent debt at a time when D is insolvent.[296] As a matter of state law, "payment" of this dollar extinguishes TBC's claim and constitutes D's final alienation of the dollar to TBC.[297]

Federal voidable preference law, however, adds to this simple description. The dollar paid might be voidable if D files for bankruptcy within ninety days. If so, the trustee may recover the exact dollar conveyed.[298] If the dollar has been commingled or cannot be found, TBC has *in personam* liability and therefore owes a debt to the trustee.[299] This *in personam* liability is in the nature of the tort of conversion.[300]

The *in rem* ability to recover the dollar as such (and not the value of the dollar) is proved by reference to TBC's transfer of the voidable dollar to a third party (*X*).[301] If TBC were to give the voidable dollar to *X*, *X* takes subject to the trustee's future interest.[302] In the language of the Code, *X* is the transferee of a transferee and is liable for the return of the dollar as such or, if it cannot be located, for the value of the missing dollar.[303]

296. The dollar must be unencumbered. If the dollar is already encumbered by TBC's security interest, then the hypothetical liquidation test always prevents the trustee's prima facie case of voidable preference. *See* David Gray Carlson, *Voidable Preferences and Proceeds: A Reconceptualization*, 71 AM. BANKR. L.J. 517, 533-37 (1997).

297. *See id.* at 537.

298. 11 U.S.C. § 550(a) (1994).

299. *Id.*

300. Burmeister v. Wilcox (*In re* Wilcox), 194 B.R. 631, 635 (Bankr. W.D. Mo. 1996).

301. 11 U.S.C. § 550(b)(1).

302. *Id.*

303. *Id.* § 550(a)(2).

To be sure, *X* has a defense if *X* is a good faith transferee for value of that dollar.[304] Such a defense merely implies that TBC held a "voidable" title in trust for D's bankruptcy trustee.[305] To state the matter in slightly different words, TBC had a legal title to the dollar, but the bankruptcy trustee had equitable title (which lapses at the end of the preference period, if no bankruptcy ensues).[306]

AS APPLIED TO LETTERS OF CREDIT

Everything said about the dollar bill is likewise true of the letter of credit issued on antecedent debt to an unsecured TBC during the preference period. We have seen that issuance of the letter of credit itself is a transfer of D's property.[307] Hence, when the letter of credit is issued, D finally alienates its property. This is the proper meaning of the independence principle. But, as a matter of federal law, D alienates the present possessory right to TBC and a future interest to a potential bankruptcy trustee. The meaning of federal voidable preference law is that TBC obtains only the equivalent of a fee simple on executory limitation on the letter of credit. A future bankruptcy trustee obtains an executory interest.

Suppose TBC draws on this encumbered letter of credit prior to the bankruptcy petition. At that moment, TBC is the rightful present possessor of the letter of credit, but TBC holds this right in trust for the future bankruptcy trustee. Hence, TBC rightfully draws, and IB rightfully pays. By paying, IB commits no wrong against the bankruptcy trustee, whose property interest in the letter of credit was then only executory. IB's position in this respect is similar to a bailee of D's property prior to bankruptcy. If a bailee follows D's instructions in disposing of that property, the bailee acts lawfully.

In the case of IB's prepetition payment of a letter of credit, IB discharges IB's liability to TBC. TBC, who held the letter of credit in trust for a future bankruptcy trustee, now holds proceeds. These proceeds are likewise charged with the trust that encumbered the letter of credit. Hence, TBC holds proceeds in trust for the future bankruptcy trustee.

VOIDABLE TRANSFERS AS PROPERTY OF THE ESTATE

In some of the reported cases, TBC has received the letter of credit during the preference period, but has not drawn on it by the time of the bankruptcy petition.[308] It is this situation in which beneficiaries and banks

304. *Id.* § 550(b)(1).

305. *Id.*

306. Carlson, *supra* note 296, at 520-23.

307. *See supra* text accompanying notes 105-12.

308. *See e.g.,* American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293, 295 (11th Cir. 1988); Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 589 (5th Cir. 1987), *modified,* 835 F.2d 584 (5th Cir. 1988).

may face a risk if a letter of credit is presented for payment. Whether this risk exists depends on the precise theory of the bankruptcy estate adopted by a court.[309]

On the one hand, if voidably conveyed property enters into the bankruptcy estate immediately upon the filing of a bankruptcy petition, then IB ought not to honor draws whenever they are voidable preferences—something IB will not be able to ascertain, in many cases. Such a result is commercially untenable. TBC's draw would be in violation of the automatic stay.[310] IB will not have violated the automatic stay, but it will have to pay D's bankruptcy trustee a second time. On the other hand, if one says that the initial transferee of voidably conveyed property retains a present right of possession until the trustee actually *recovers* the property, then IB rightfully honors a draw (without liability for double payment), even though the letter of credit itself is a voidable preference and even though the draw is postpetition.

This second theory is the one that banks need if they are to avoid a double liability on letters of credit that are (or eventually will be) declared voidable preferences. This theory relies on the fact that voidably conveyed property enters the estate through the postern gate of section 541(a)(3). Section 541(a)(3) holds that the estate is comprised of certain designated items, including: "any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723."[311] The trustee *can* recover the letter of credit under section 550(a)(1)—but typically has not yet done so.[312] Perhaps, then, the letter of credit is not part of the bankruptcy estate, prior to its actual recovery. Or to restate the principle in different words, the estate has a future interest in the voidable preference, but no present right to collect until the trustee "recovers" under section 550.

***Property* Ab Initio**

The first theory states that a trustee has the right to possess voidably conveyed property *ab initio*. This is the theory that could disrupt banking practice with regard to letters of credit. The theory states that the bankruptcy trustee has a present possessory right to the letter of credit as soon as the bankruptcy petition is filed.

If this is the operative theory of the bankruptcy estate, section 542(b) requires IB to pay the letter of credit to the trustee. According to section 542(b):

> Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is mature,

309. The relevant theories of the bankruptcy estate are thoroughly analyzed in Carlson, *supra* note 17, at 573-79.

310. *See* 11 U.S.C. § 362(a)(3).

311. *Id.* § 541(a)(3).

312. *Id.* § 550(a)(1).

> 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.[313]

Under this provision, IB is an entity that owes a debt that is property of the estate. Historically, this debt was never owed to D. Rather, it was owed to TBC. But the debt itself is precisely the thing that was voidably conveyed as proceeds of D's property. Hence, the debt becomes "property of the estate" under the *ab initio* theory under discussion,[314] and, per the terms of Code section 542(b), the letter of credit must be paid to the trustee, once it is "mature."[315] Until TBC presents documents, this debt is not mature. Should the presentment ever be made post-petition, IB must pay the letter of credit to the trustee, not to TBC.

Section 542(c) provides a defense in some cases. According to section 542(c):

> Except as provided in section 362(a)(7) of this title, an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate, or pay a debt owing to the debtor, in good faith and other than in the manner specified in subsection (d) of this section, to an entity other than the trustee, with the same effect as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been commenced.[316]

This provision requires that IB have no knowledge of D's bankruptcy petition. Often, however, IB will be aware of the bankruptcy and will be called upon to pay. If IB does pay, IB faces liability under section 542(b),[317] and nothing in section 542(c) shields IB from double liability. This is the situation if voidably conveyed property belongs to the estate *ab initio.*

The issue at hand is: When does the bankruptcy trustee have a present possessory right to voidably conveyed property? As soon as this occurs, the letter of credit is a "debt" that is property of the estate, and section 542(b) applies to the bank.[318] To investigate this question, one must set forth the mechanism by which voidably conveyed property enters the bankruptcy estate.

Section 541(a) lists the property included in a bankruptcy estate.[319] Whether this is the *exclusive* definition of the estate will be addressed soon.

313. *Id.* § 542(b).
314. *Id.*
315. *Id.*
316. *Id.* § 542(c).
317. *Id.*
318. *Id.* § 542(b).
319. *Id.* § 541(a).

For now, if a segment of section 541(a) can be identified that brings voidably conveyed property into the bankruptcy estate *ab initio*, then IB faces a double liability if it pays a letter of credit to TBC.

According to section 541(a)(1), the bankruptcy estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case."[320] Can one say that D has an interest in the letter of credit voidably conveyed? If so, then the letter of credit enters the estate *ab initio*.

We have suggested that, analytically, when the letter of credit is issued, D has alienated its property once and for all.[321] Immediately after the letter of credit is issued, TBC owns the present possessory right, and a future bankruptcy trustee owns an executory interest in the credit. Hence, it would appear that a voidably conveyed letter of credit cannot enter the estate *ab initio* under section 541(a)(1).

The case law, however, is very troubling on the scope of section 541(a)(1). In the leading case of *American National Bank v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*,[322] a private creditor attempted to expropriate fraudulently conveyed property, even though the debtor was in bankruptcy. The bankruptcy trustee claimed the creditor's pursuit of the fraudulent conveyance violated the automatic stay. This proposition would be true if the trustee could show that the voidably conveyed property was already in the bankruptcy estate at the time the creditor commenced an action against such property[323]—though perhaps other theories would have sustained the automatic stay.[324]

Judge Carolyn Randall[325] ruled that the debtor continued to own fraudulently conveyed property, even after the debtor's deed of gift was final.[326] Hence, such property must have entered the estate *ab initio* under Code section 541(a)(1). For this reason, the automatic stay prevented individual creditors from pursuing fraudulent conveyance actions that the bankruptcy trustee would pursue for the common good of all.

In so ruling, Judge Randall cited the awkward phraseology of fraudulent conveyance law[327]—a phraseology that speaks of conveyances being "set aside."[328] Under such formulations, what the debtor gave away seems to

320. *Id.* § 541(a)(1).

321. *See supra* text accompanying notes 296-307.

322. 714 F.2d 1266 (5th Cir. 1983).

323. *See* 11 U.S.C. § 362(a)(2), (3).

324. *See* Carlson, *supra* note 17, at 579.

325. After January 1, 1988, Judge Randall was listed under the name Judge Carolyn Dineen King.

326. *MortgageAmerica Corp.*, 714 F.2d at 1277.

327. *Id.* at 1273 ("The basic principle of a fraudulent transfers act, according to one court, is that 'as to the creditors, the property continues in the debtor, and it or its proceeds are liable to the creditors' demands.' ") (citing Hallack v. Hawkins, 409 F.2d 627, 630 (6th Cir. 1969)).

328. UNIF. FRAUDULENT CONVEYANCE ACT § 9(a) (1918).

remain with the debtor, so that a creditor's judicial lien might attach to it. Such language permitted Judge Randall to say that the debtor still owns property it gave away:

> An action under the Fraudulent Transfers Act is essentially one for property that properly belongs to the debtor and which the debtor has fraudulently transferred in an effort to put it out of the reach of creditors. The transferee may have colorable title to the property, but the equitable interest—at least as far as the creditors (but not the debtor) are concerned—is considered to remain in the debtor so that creditors may attach or execute judgment upon it as though the debtor had never transferred it. We think that when such a debtor is forced into bankruptcy, it makes the most sense to consider the debtor as continuing to have a "legal or equitable interest" in the property fraudulently transferred within the meaning of section 541(a)(1) of the Bankruptcy Code.[329]

In this passage, however, Judge Randall effectively admits that what the debtor conveyed away is *not* debtor property, so far as the debtor is concerned. It is only debtor property so far as individual creditors are concerned. This is tantamount to admitting that the debtor has no remaining property in what it fraudulently conveyed. Rather, this property belongs solely to the transferee and to the creditors, whose judicial liens might attach to the transferee's property.[330] The transferee has a present possessory right, and the creditors have a future right to attach judicial liens to this property, under which the initial transferee might be divested of her property. The debtor has nothing whatever.

The better description of avoidance than that which *MortgageAmerica* supplies is that the debtor alienates the voidably conveyed property forever. In the case of fraudulent conveyance, individual creditors receive a kind of future interest in the thing (and a future bankruptcy trustee separately obtains a future interest by virtue of section 548(a)). The transferee has the balance of the title. In the case of preference law, a potential bankruptcy trustee has a future interest in the voidably conveyed property. The initial transferee of the property has the balance of the title. The debtor owns nothing.

Nevertheless, Judge Randall was able to rely on remarks by the U.S. Supreme Court in *United States v. Whiting Pools, Inc.*,[331] that do indeed sup-

329. *MortgageAmerica Corp.*, 714 F.2d at 1275.

330. Judge Randall more plausibly characterized a "trust fund" theory as property of the debtor prior to bankruptcy. She reasoned that such a cause of action could be brought by a creditor or a shareholder, but it must be brought for both groups as a whole. Individual remedies did not exist. Because the action was one that unified both the creditors and the shareholders, and because the very personhood of the corporate debtor was this very unity, the action should be viewed as belonging to the unity—that is, to the debtor. *Id.* at 1269-72.

331. 462 U.S. 198 (1983).

port her position,[332] however correct or incorrect these remarks may be on their own merit. As *Whiting Pools* is the Supreme Court's principal statement on the composition of the bankruptcy estate, it bears careful analysis.

In *Whiting Pools*, a debtor-in-possession wished to recover over-encumbered inventory seized by the Internal Revenue Service (IRS), so that the inventory could be used to rehabilitate the debtor. In deciding for the debtor-in-possession, Justice Harry Blackmun had to solve the following problem: where D has granted a valid perfected security interest on a thing to A, is the entire thing in the estate, or only D's interest in the thing? Section 541(a)(1) makes only "legal or equitable interests of the debtor in property" part of the estate.[333] Yet, once the IRS repossessed inventory, the debtor had no right to possess it—not without redeeming it by paying the underlying debt. The debtor had only the right to receive any cash surplus. A Chapter 11 debtor may use "property of the estate."[334] But where the debtor had no possessory right at the time of the bankruptcy petition, how could the debtor-in-possession possess the inventory, which was out of the estate? Somehow the possessory right had to be brought inside the estate.[335]

To solve this problem, Justice Blackmun remarked that property of the estate exceeds the narrow words of section 541(a): "[a]lthough these statutes could be read to limit the estate to those 'interests of the debtor in property' at the time of the filing of the petition, we view them as a definition of what is included in the estate, rather than as a limitation."[336] The point of this remark is to establish that property in the bankruptcy estate exceeds property described by the words of section 541(a)(1).[337] Thus, the estate includes not only the debtor's interest in a thing, but the *whole* thing, including the IRS' rights in the thing. Under this dictum, because the trustee can use "property of the estate,"[338] the trustee can use the whole of a secured party's collateral.

Somewhat separately, Justice Blackmun also comments: "[m]ost important, in the context of this case, § 541(a)(1) is intended to include in the estate any property made available to the estate by other provisions of the

332. *MortgageAmerica Corp.*, 714 F.2d at 1275-76 ("The [U.S.] Supreme Court has, in fact, expressly noted that section 541(a)(1) is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code, which would include property made available through section 544.") (citing *Whiting Pools, Inc.*, 462 U.S. at 205).

333. 11 U.S.C. § 541(a) (1994).

334. *Id.* § 363(b)(1), (c)(1).

335. For an argument that such inventory could *not* be recovered and that *Whiting Pools* was wrongly decided, see Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193, 1234-46 (1998).

336. *Whiting Pools, Inc.*, 462 U.S. at 203.

337. 11 U.S.C. § 547(a)(1).

338. *Id.* § 363(b)(1).

Bankruptcy Code."[339] The "other provision" Blackmun had in mind was the turnover provision.[340] But, elsewhere, he makes clear that the avoidance provisions too are included within the terms of section 541(a)(1):

> Indeed, if this were not the effect, § 542(a) would be largely superfluous in light of § 541(a)(1). Interests in the seized property that could have been exercised by the debtor—in this case, the rights to notice and the surplus from a tax sale—are already part of the estate by virtue of § 541(a)(1). No coercive power is needed for this inclusion. The fact that § 542(a) grants the trustee greater rights than those held by the debtor prior to the filing of the petition is consistent with other provisions of the Bankruptcy Code that address the scope of the estate. See, *e.g.*, § 544 (trustee has rights of lien creditor); § 545 (trustee has power to avoid statutory liens); § 549 (trustee has power to avoid certain postpetition transactions).[341]

In the list of avoidance powers included in section 541(a)(1), Justice Blackmun did not cite to section 547 (voidable preferences), or section 548 (fraudulent conveyances), but he does so explicitly elsewhere in the opinion.[342] Hence, all avoided property arguably comes into the estate under section 541(a)(1). As such, the automatic stay prevents any attempt to "control" the voidably conveyed property.

Under this reading of *Whiting Pools*, letters of credit that are voidable preference are in the estate *ab initio*. This principle would trigger IB's section 542(b) liability to make payments on the letter of credit to the bankruptcy trustee.[343] On this premise, IB must not honor the letter of credit by paying TBC after D's bankruptcy for fear of double liability. This result obviously is commercially untenable. Notwithstanding that this untenable result is implied by Supreme Court dicta, another theory is being used by courts that does not have this draconian impact.

Property Only When Recovered

As we have described letters of credit, D has alienated the credit forever when IB issues the letter of credit to TBC.[344] All that federal law adds is that the bankruptcy trustee has a future interest in the letter of credit if the requirements of a voidable preference are met. The issue then becomes: What are the conditions precedent to the trustee's present possessory right?

339. *Whiting Pools, Inc.*, 462 U.S. at 205; *see also* 11 U.S.C. § 541(a)(1).

340. 11 U.S.C. § 542(a).

341. *Whiting Pools, Inc.*, 462 U.S. at 207 n.15.

342. *Id.* at 205 (stating that "[s]everal of these provisions bring into the estate property in which the debtor did not have a possessory interest at the time the bankruptcy proceedings commenced") (citing 11 U.S.C. §§ 547, 548).

343. 11 U.S.C. § 542(b).

344. *See supra* text accompanying notes 296-307.

The filing of a bankruptcy petition within the preference period is surely one of them. The theory in the last section also insisted that it was the *only* condition precedent.[345] Such a theory imposes a risk of double liability on IBs that issue letters of credit on TBC's antecedent debt.

An alternate theory protects IB against this risk. This theory is that *recovery* is a second condition precedent upon the trustee's present possessory rights. Until recovery occurs, TBC is in rightful possession of the letter of credit, and IB may rightfully pay a draw without risk of double liability.

Section 541(a)(3) holds that the estate is comprised of certain designated items, including: "[a]ny interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723."[346] The trustee *can* recover the letter of credit under section 550(a)(1)[347]—but has not yet done so. Perhaps, then, the letter of credit is not part of the bankruptcy estate, prior to its actual recovery. To restate the principle in different words, the estate has a future interest in the letter of credit, but no present right to collect until the trustee "recovers" under section 550.[348] The letter of credit comes into the bankruptcy estate under section 541(a)(3)[349] but not under section 541(a)(1).[350]

In support of this proposition is the fact that the trustee never avoids a transaction unless she brings an "adversary proceeding" within the meaning of Rule 701 of the Federal Rules of Bankruptcy Procedure.[351] So conceived, recovery of the letter of credit is conditioned on the adversary proceeding; without it, the letter of credit never enters the bankruptcy estate in the first instance. Without a judgment in the adversary proceeding, TBC rightfully possesses the voidable dollar.[352]

345. *See supra* text accompanying notes 319-42.

346. 11 U.S.C. § 541(a)(3).

347. *Id.* § 550(a)(1).

348. As to this alternative theory of the bankruptcy estate, Judge Randall, in *MortgageAmerica*, remarked:

> The other possibly relevant provision in section 541 is section 541(a)(3), which provides that property of the estate includes "[a]ny interest in property that the trustee recovers under section 543, 550, 553, or 723 of [the Bankruptcy Code]". . . . In view of our disposition of this case, it is unnecessary for us to decide whether the phrase "[a]ny interest in property that the trustee recovers" may be read "might recover" at some time in the future. It is, therefore, unnecessary for us to rely upon the definition of "property of the estate" provided in section 541(a)(3).

American Nat'l Bank v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1273-74 n.7 (5th Cir. 1983).

349. 11 U.S.C. § 541(a)(3).

350. *Id.* § 541(a)(1).

351. *See* Brady v. Andrew (*In re* Commercial W. Fin. Corp.), 761 F.2d 1329, 1336 (9th Cir. 1985).

352. *But see* United States v. Nordic Village, Inc., 503 U.S. 30, 37 (1992) (stating that "the right to recover a postpetition transfer under § 550 is clearly a 'claim' (defined in § 101(4)(A))

This view has been embraced by the Second Circuit in *Federal Deposit Insurance Corp. v. Hirsch (In re Colonial Realty Co.)*,[353] where Judge Daniel Mahoney renounced *MortgageAmerica*[354] and held that voidably conveyed property enters the bankruptcy estate only by means of section 541(a)(3).[355] On this view, the future interest of the trustee to recover is in the estate, but the present possessory right is beyond the estate. Hence, IB does the trustee no wrong when it pays the draw to TBC—the present possessor of the letter of credit—and not the trustee pursuant to section 542(b).[356]

In *Colonial Realty*, the issue was the same as it was in *MortgageAmerica*: Could private creditors pursue fraudulent conveyances made by the debtor once the debtor was in bankruptcy?[357] As the Fifth Circuit did in *MortgageAmerica*, the Second Circuit held that the automatic stay prevented such lawsuits, but on grounds much different from those which prevailed in *MortgageAmerica*.[358] Specifically rejecting *MortgageAmerica*'s reliance on section 541(a)(1), Judge Mahoney incorporated by reference the analysis to be found in *In re Saunders*,[359] where Judge Lewis Killian wrote:

> [w]e think that the inclusion of property recovered by the trustee pursuant to his avoidance powers in a separate definitional subparagraph [i.e., Code section 541(a)(3)] clearly reflects the congressional intent that such property is not to be considered property of the estate until it is recovered. Until a judicial determination has been made that the property was, in fact, fraudulently transferred, it is not property of the estate. If it were, the trustee could simply use a turnover action under 11 U.S.C. § 542, and the two (2) year statute of limitations of § 546(a) for actions under §§ 544 and 548 could be avoided.[360]

and is 'property of the estate' (defined in §541(a)(3))"). This passage indicates that the U.S. Supreme Court considers a mere claim not yet recovered to be "property of the estate." *See* 11 U.S.C. § 541(a)(3).

353. 980 F.2d 125 (2d Cir. 1992).

354. The theory of this case is discussed *supra* text accompanying notes 322-43.

355. *Colonial Realty Co.*, 980 F.2d at 131; *see* 11 U.S.C. § 541(a)(3).

356. It bears emphasis that New York is the world leader in issuance of letters of credit. The theory adopted in *Colonial Realty* is important, therefore, to New York commercial practice.

357. *Colonial Realty Co.*, 980 F.2d at 131.

358. *Id.* at 132.

359. 101 B.R. 303 (Bankr. N.D. Fla. 1989).

360. *Id.* at 305; *accord* Federal Deposit Ins. Corp. v. Hirsch (*In re* Colonial Realty Co.), 980 F.2d 125, 130-32 (2d Cir. 1992); Grossman v. Murray (*In re* Murray), 214 B.R. 271 (Bankr. D. Mass. 1997). Some of these claims could be disputed. For instance, if turnover were an adjunct to actions under Code § 544, then turnover can last only so long as the § 544 theory lasts.

If fraudulent conveyances do not enter the estate *ab initio*, how then can the automatic stay prevent private creditors from pursuing fraudulent conveyances on their own, in competition with the bankruptcy trustee? Judge Killian reasoned that creditors were barred by the automatic stay under section 362(a)(1), which prohibits

> 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.[361]

Judge Killian opined that, because a fraudulent conveyance action turned on the creditor's rights against the debtor, then pursuit of a third party was the same as pursuit of the debtor. Hence, pursuit of the third party was stayed under section 362(a)(1).[362]

The trouble with this view, however, is that it suggests that the automatic stay protects all sureties of the debtor, because all such actions are founded on claims against the debtor as well. A principle that brings all sureties under the automatic stay is far more calamitous to commercial law than allowing private creditors to pursue fraudulent conveyances. In any case, this theory does no harm to letters of credit, no matter what havoc and confusion may reign in suretyship law. It can be said of letters of credit that, because IB's obligation is "independent" of the debtor, section 362(a)(1) does not stay the collection of a letter of credit.

To summarize, the trustee eventually has a present right to possess voidably conveyed property—including a letter of credit (and its proceeds) that constitutes a preference. This right of possession may arise immediately once the bankruptcy petition is filed. Or it may arise only later, requiring *recovery* under section 550. Prior to these conditions precedent on the trustee's present possessory right—that is, prior to bankruptcy and perhaps prior to recovery—D has alienated the letter of credit completely as a matter of state law. D has conveyed the present possessory right in this letter of credit to TBC. Until the bankruptcy petition is filed, TBC is rightfully in possession of the credit and may draw on it. IB rightfully pays any prepetition draw. But D has also conveyed a future interest in the letter of credit to a potential bankruptcy trustee. Hence, TBC never gets a "fee simple absolute" in any letter of credit issued on antecedent debt. Rather, TBC gets a "fee simple on an executory limitation," and the bankruptcy trustee obtains an "executory interest" in the credit. In other words, TBC's right to possess the letter of credit is divested when the debtor files for bankruptcy within ninety days and (perhaps) when the trustee recovers

361. *Saunders*, 101 B.R. at 305 (citing 11 U.S.C. § 362(a)(1)).

362. *Id.*; *see also* 11 U.S.C. § 362(a)(1) (1994).

within the meaning of section 541(a)(3). If this second condition precedent of actual recovery does not exist, IB might face double liability in bankruptcy if our reformulation is adopted. In the vast number of cases, of course, no risk of liability exists because letters of credit are not issued in an ALCT.

RESPONSES TO POSTPETITION RISK

The last two sections described two competing theories of the bankruptcy estate. Under the first theory, voidably conveyed property enters the bankruptcy estate immediately. TBC would then automatically be stayed from drawing the letter. IB would be enjoined by section 542(b)[363] from paying TBC (rather than the trustee) and IB would be subject to a double liability if it does pay TBC. Because the exact status of the bankruptcy estate is so undertheorized, it is impossible to state which theory will prevail on its own merits, although it is clear that only the second theory creates a commercially comfortable environment for IBs. The most that can be said is that, if courts wish to protect the IB, they should seize upon the second theory of the bankruptcy estate to protect IB (or come up with a judge-made exception to the first theory). Yet, the second theory potentially brings sureties under the aegis of the automatic stay if we follow Judge Killian in *In re Saunders*[364]—an undesirable side effect. This side effect does not occur if we permit private creditors to pursue claims, subject to potential turnover of proceeds of those efforts to a trustee.[365]

Assuming for the moment that voidable preference law creates a risk of double liability on letters of credit, there are two possible responses. First, the risk might be dealt with by an injunction against TBC's draw on a letter of credit that belongs to the trustee. Second, the logic of bankruptcy law can simply be rejected in favor of "policy intuitions of a legislative character,"[366] to use Justice Scalia's memorable phrase. Each of these possibilities will be investigated in the following sections.

363. 11 U.S.C. § 542(b).

364. *Saunders*, 101 B.R. at 305.

365. One possibility is that the present possessory right to avoid fraudulent conveyances does indeed lie with private creditors. The automatic stay does not prevent these law suits, because the present possessory right is beyond the bankruptcy estate. Nevertheless, this present possessory right is encumbered by the trustee's superior federal rights. These rights would arise under § 548(a) and also under § 544(b), which subrogates the trustee to actual rights of unsecured creditors to avoid debtor transfers. *See* 11 U.S.C. §§ 548(a), 544(b). Indeed, § 544(b) suggests that the very right asserted by a private creditor is expropriated for the benefit of the bankruptcy estate. In short, perhaps a private creditor can pursue her rights free of the automatic stay, but whatever is recovered ultimately belongs to the trustee. This must be the position taken if (i) present possessory rights to voidably conveyed property do not enter the estate *ab initio* and (ii) pursuing third parties does not violate the automatic stay.

366. Dewsnup v. Timm, 502 U.S. 410, 422 (1992) (footnote omitted) (Scalia, J., dissenting).

Injunctions

If it is accepted that this risk truly exists, one way of addressing it is for IB or a bankruptcy trustee to obtain an injunction against presentment or payment of a letter of credit that is a voidable preference. It would be an unusual role for IB to seek an injunction against payment of its own letter of credit (though IB sought nullification of a letter of credit in *Air Conditioning*).[367]

Injunctions might issue on these grounds: (i) possibility of irreparable harm to the debtor's estate; (ii) likelihood of success on the merits; (iii) whether the possible harm to the estate outweighs the possible harm to the beneficiary; and (iv) the public interest.[368] All of these are likely to be the case where the trustee can prove the elements of voidable preference. Payment of the letter of credit removes the assets from control of the estate. Where TBC might be insolvent or unreachable by process, the bankruptcy estate could be harmed. The trustee's success on the merits is, *ex hypothesi*, guaranteed. The risk to the trustee surely outweighs the harm to TBC, who has no ultimate entitlement to the funds. Finally, the public interest favors discouragement of preference, though admittedly banks and beneficiaries alike are capable of waxing eloquent on the public benefits of absolutely reliable letters of credit.[369] These policies must be balanced, and, naturally, courts are capable of disagreeing on how the balancing test should come out.

Because the trustee has a property right in the letter of credit itself, it should be possible for IB or D's trustee to obtain an injunction preventing IB from paying or TBC from collecting the letter of credit. This is so whether the trustee has a *present* right to voidably conveyed property, or whether the trustee's present right awaits a "recovery," per section 541(a)(3).[370] Even the future interest of the trustee would sustain the injunction, if harm to the trustee outweighs harm to TBC.

As is well-known, injunctions against payment of letters of credit are available in cases of fraud. One commentator describes the "fraud" exception to the independence principle as follows:

> Even in fraud cases the courts uphold the independence of letters of credit unless the wrongdoing of the beneficiary has "so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served." Thus, courts have upheld payment when the documents have some basis in fact, but have enjoined payment when the beneficiary has no bona fide claim to payment, as in a commercial letter of credit when the ben-

367. American Bank v. Leasing Serv. Corp. (*In re* Air Conditioning, Inc.), 845 F.2d 293 (11th Cir. 1988).

368. Moringiello, *supra* note 5, at 637.

369. *See, e.g.*, *id.* at 643-48.

370. 11 U.S.C. § 541(a)(3).

> eficiary ships worthless material intended to simulate actual merchandise.[371]

If fraud establishes that TBC has no bona fide claim to payment, so does voidable preference law. Fraud suggests that the transaction between D and TBC might be rescinded; pending rescission, TBC holds the letter of credit in trust for D. The injunction is a natural corollary to the property interest that D has in the letter of credit itself, when fraud vitiates the independence principle.

As we have seen, voidable preference has the same effect.[372] It makes D's bankruptcy trustee the owner of the letter of credit itself, and so the same predicates of the injunction are fully present when TBC's receipt of the letter of credit was a voidable preference.

Leasing Service Corp. v. Wendel (In re Air Conditioning, Inc.)[373] ought not to be taken as authority against any such injunction. In *Air Conditioning*, IB sought a declaration that the letter of credit itself was nullified, and that TBC could not collect under it. The bankruptcy court granted this declaratory relief.[374] The case was, therefore, a declaratory relief case, not, properly speaking, an injunction case.[375]

On appeal, district court Judge Lenore Nesbitt reversed.[376] She thought that the independence principle prevented the nullification of the letter of credit.[377] On this narrow point, she was correct. The letter of credit established IB's obligation to TBC. Voidable preference law cannot "nullify" this obligation.[378] But it does proclaim that the obligation potentially belongs to the bankruptcy trustee. Hence, an injunction is appropriate, but the nullification order was not. Nothing in *Air Conditioning* stands in the way of an injunction when a letter of credit is a voidable preference.

371. Moringiello, *supra* note 5, at 646.

372. *See supra* text accompanying notes 362-63.

373. 72 B.R. 657 (S.D. Fla. 1987), *modified*, 845 F.2d 293 (11th Cir. 1988).

374. *Air Conditioning, Inc.*, 845 F.2d at 295.

375. For praise of this decision, see Steven R. Gross & Peter L. Borowitz, *A New Twist on* Twist Cap*: Invalidating a Preferential Letter of Credit in* In re Air Conditioning, 103 BANKING L.J. 368 (1986). These authors write:

> Once the banking community recovers from the initial shock of witnessing the invalidation of a letter of credit in *Air Conditioning*, it should come to the conclusion that the decision correctly harmonizes the policies underlying letter-of-credit law . . . *Air Conditioning* does not in any way detract from the luster of the letter of credit in the vast majority of transactions where its inviolability is critical—when the beneficiary is willing to extend credit only against the protection of a contemporaneous letter of credit.

Id. at 376.

376. *Air Conditioning, Inc.*, 72 B.R. at 663.

377. *Id.* at 662.

378. For one thing, anything "avoided" under § 547 is automatically preserved for the estate under § 551. *See* 11 U.S.C. §§ 547, 551 (1994).

Even if voidably conveyed property enters the estate only after recovery (per the second theory), an injunction still should be possible. The trustee's recovery would be a future interest in the letter of credit itself. This future right should be quite enough to sustain an injunction, if the trustee's success on the merits is probable and the detriment to TBC is outweighed. The point is that, under the second theory, absent the injunction IB may honor the letter of credit without violating the automatic stay *and* without sustaining a double liability under section 542(b).[379] Thus trustees, but not IBs, would be in the business of seeking injunctions. This latter result is the only one that fully protects an IB.

The Bank of Marin *Case*

In place of an injunction, banks also may seek a judicial declaration that section 542(b) is subject to an implicit equitable exception in favor of letters of credit. Obviously such a declaration would be legislative in character, and those courts who believe that voidably conveyed property enters the estate *ab initio* would be in the position of overriding the Bankruptcy Code in order to protect postpetition draws on letters of credit.

Once before in bankruptcy history, the U.S. Supreme Court carved out an equitable exception from the turnover provision in spite of the plain meaning of the bankruptcy statute. In *Bank of Marin v. England*,[380] a debtor wrote a check before bankruptcy that was presented to the payor bank after bankruptcy. Although the plain meaning of the Bankruptcy Act was that the bank was liable to pay over the checking account as it existed on the day of the bankruptcy petition,[381] the Court ruled that the bank had a defense against the trustee's turnover proceeding.[382]

Bank of Marin has now been ratified by Congress in section 546(c).[383] This section, however, is of no aid in letter of credit cases, unless IB happens to pay TBC without knowledge that D has filed for bankruptcy.

Nevertheless, the *Bank of Marin* case stands for the proposition that courts may, from time to time, for good reason create equitable exceptions to the turnover power.[384] Just such an exception may be merited in letter of credit cases if the first theory of the bankruptcy estate is utilized.[385]

379. *Id.* § 542(b).

380. 385 U.S. 99 (1966).

381. *Id.* at 101.

382. *Id.* at 103.

383. 11 U.S.C. § 546(c).

384. Justice Harlan thus complained in dissent: "The Court's disposition of this case may be taken to suggest that whenever equity is thought strongly to demand relief from the strictures of the Act, further exceptions may be appropriately created to the statutory scheme." *Bank of Marin*, 385 U.S. at 110 (Harlan, J., dissenting).

385. In suggesting that a court-made exception be developed, if necessary, to protect IBs from the *ab initio* theory in letter of credit cases, the following objection may be advanced. So long as exceptions to the Code are licensed, why not simply license a direct exception to

The exception is not needed if the voidable preference enters the estate only through section 541(a)(3), as the Second Circuit has held.[386] It is needed only if the Fifth Circuit's theory is followed—that voidably conveyed property enters the estate immediately upon filing of the petition via section 541(a)(1).[387]

Usually, courts provide this equitable exception covertly in the name of honoring the independence principle. The analysis shows, however, that the independence principle—a state law precept—cannot negate the idea that the debtor transfers its own property when it causes its bank to issue a letter of credit.[388] Hence, invocation of the independence principle should be understood as an implicit exception to section 542 and a reinstitution of the *Bank of Marin* case in the context of letters of credit.

It must also be acknowledged that the Court lately has been attempting to curb the use of equity to override the plain meaning of the Bankruptcy Code.[389] Nevertheless, an exception—overt or covert—may be what is needed to save the banks from liability if the trustee owns the

Deprizio analysis with regard to letters of credit, while otherwise retaining the classic analysis? The exception would state that, in an *Air Conditioning* type ALCT, you could not pursue IB but only TBC for the security interest.

This suggestion is inadvisable. This exception would not permit recovery from TBC in a *Compton* type ALCT. Recovery from TBC in that case requires retention of the "two transfer" theory for letter of credit cases, but nowhere else. As we have shown, the two transfer theory is itself hopelessly confused.

Additionally, such an exception contradicts the very strong trend among appellate courts to affirm the basic logic of *Deprizio*. *See* Galloway v. First Alabama Bank (*In re* Wesley Indus., Inc.), 30 F.3d 1438 (11th Cir. 1994); Clark v. Balcor Real Estate Fin., Inc. (*In re* Meredith Hoffman Partners), 12 F.3d 1549 (10th Cir. 1993); Official Unsecured Creditors Comm. v. United States Nat'l Bank (*In re* Suffola, Inc.), 2 F.3d 977 (9th Cir. 1993); Ray v. City Bank & Trust Co. (*In re* C-L Cartage Co.), 899 F.2d 1490, 1494-95 (6th Cir. 1990). *But see* T.B. Westex Foods, Inc. v. Federal Deposit Ins. Corp. (*In re* T.B. Westex Foods, Inc.), 950 F.2d 1187, 1194 (5th Cir. 1992).

On the other hand, the U.S. Supreme Court, in *Bank of Marin*, has previously legislated a narrow exception to the turnover power, and this has been ratified after the fact by Congress, which enacted § 542(c) on the basis of it. In any event, the exception is not needed if you prefer the second theory of the bankruptcy estate as protection for IBs. However, if required because the first theory prevails, this further exception on behalf of IBs, is far less disruptive than intervening into the complex and intricate context of *Deprizio* liability. It has the further advantage of correcting a problem caused by the Court itself in its *Whiting Pools* dicta. *See supra* text accompanying notes 331-43. These dicta gave rise to the very *ab initio* theory that our proposed exception would correct.

386. *See supra* text accompanying note 353.

387. *See supra* text accompanying notes 325-26.

388. *See supra* text accompanying notes 92-96.

389. *See, e.g.*, Norwest Bank v. Ahlers, 485 U.S. 197, 206 (1988) ("The short answer to these arguments is that whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.").

letter of credit *ab initio* because it was conveyed in violation of section 547.[390]

CONCLUSION

Courts have allowed a false view of the independence principle to influence their decisions when letters of credit are implicated in voidable preferences. They suppose that the independence principle proves that the debtor never transfers property to an unsecured creditor when it causes a bank to issue a letter of credit to such a creditor. The independence principle stands for no such thing. Rather, it stands for the proposition that, once the letter of credit is issued, the bank must pay the beneficiary of the letter. The debtor may not countermand it, and the bankruptcy of the debtor cannot affect the bank's obligation to pay.

Voidable preference law, however, encumbers the letter of credit with a future interest in favor of a bankruptcy trustee. When the bankruptcy estate is created upon filing a petition, the letter of credit itself may become property of the estate *ab initio* because the trustee may recover the letter of credit under section 550(a).[391] The letter of credit therefore may constitute "a debt that is property of the estate" within the meaning of section 542(b).[392] That section requires the bank to pay that debt to the trustee—not the beneficiary of the letter of credit.

If banks are to have the freedom to honor draws on letters of credit without risk of double payment liability in ALCTs, the law must show why letters of credit that are voidable preferences are not within the bankruptcy estate. One possibility is that voidably conveyed property is not in the bankruptcy estate *ab initio*, but only when the trustee "recovers" the voidable preference. Hence, if the draw precedes the trustee's "recovery," the letter of credit may be paid without risk of double liability. This theory adequately protects banks, though it appears to violate ill-considered dictum from the U.S. Supreme Court. If voidably conveyed property is in the estate *ab initio*, then only a court-created exception to the turnover power can save a bank that pays a letter of credit in violation of section 542(b).[393] Yet the Court itself, in *Bank of Marin v. England*,[394] has authorized the creation of equitable exceptions to the turnover power.[395] If the first theory prevails, such an exception will have to be developed to fully protect IBs.

390. 11 U.S.C. § 547 (1994).
391. *Id.* § 550(a).
392. *Id.* § 542(b).
393. *Id.*
394. 385 U.S. 99 (1966).
395. *Id.* at 103.

The best solution, following the example of the history of *Bank of Marin*, would be for Congress to amend the Code to expressly protect letters of credit, just as Congress did for check payments when it codified the protections of *Bank of Marin* in section 546(c).[396]

396. 11 U.S.C. § 546(c). The following addition to the Code § 542 would suffice:

(f) An entity that has issued a letter of credit to a beneficiary that is property of the estate may pay the beneficiary with the same effect as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been commenced, unless, prior to payment, the trustee either supplies indemnity deemed adequate by the entity liable on the letter of credit or enjoins payment or satisfaction by order of the bankruptcy court or other court of competent jurisdiction in an action in which the trustee, beneficiary and letter of credit issuer are parties.