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SILENCING THE LOOSE CANNON: THE NEED FOR THE BANKRUPTCY CODE TO RECOGNIZE LETTERS OF CREDIT

Juliet M. Moringiello*

I. INTRODUCTION

The world of commercial law is witnessing two parallel law revisions, that of Article 5 of the Uniform Commercial Code (UCC), which governs letters of credit,¹ and that of the Bankruptcy Code (Code).² This time of revision presents the legal community with the ideal opportunity to address problems that have arisen in past attempts to reconcile apparent conflicts between these two statutes, and in particular, the problem of whether a court can ever enjoin payment of a letter of credit because of an account party's bankruptcy.

Since 1979 when the decision in *Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.)*³ shocked the financial world by allowing a court to enjoin payment on letters of credit as voidable preferences in the account party's bankruptcy, courts have wrestled with the problem of the courts' power to enjoin payment of standby letters of credit⁴ in bank-

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1. In 1990 the Business Law Section of the American Bar Association created a task force to study Article 5. *L/C Trends: Whence the Revision of U.S. UCC Article 5?*, LETTER OF CREDIT UPDATE (Gov't Info. Servs.) at 3, 3 (Mar. 1993) [hereinafter *L/C Trends*]. The *Letter of Credit Update* contains a good summary of the Article 5 revision process, as well as a copy of the January 29, 1993 draft of Article 5.

2. S. 540, 103rd Cong., 1st Sess. (1993).

3. 1 B.R. 284 (Bankr. M.D. Fla. 1979).

4. Letters of credit are of two general types: commercial credits and standby credits. Originally, letters of credit were used exclusively in commercial sales transactions in order to reduce the risk of nonpayment of the purchase price under a contract for the sale of goods. See JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS* ¶ 1.04 (2d ed. 1991). Commercial letters of credit serve as a payment mechanism, and draws on commercial credits are expected in the ordinary course of business. JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 19-1 (3d ed. 1988). Generally, standby letters of credit are used in nonsales settings in order to reduce the risk of nonperformance under a contract that calls for performance. *Id.* Some common uses of standby letters of credit include securing the developer's equity in real estate development projects, securing subdivision improvements in connection with obligations under municipal regulation, see *Kerr Constr. Co. v. Plains Nat'l Bank*, 753 S.W.2d 181 (Tex. Ct. App. 1987), and guaran-

ruptcy proceedings.⁵ In the cases since *Twist Cap*, courts have suffered from a lack of statutory guidance on the issue. Article 5 of the UCC does not provide for an account party's bankruptcy.⁶ The Code, on the other hand, does not mention letters of credit.⁷ Consequently, courts have been left to strike the balance between letter of credit and bankruptcy policies, reaching conflicting results.⁸

In two 1991 cases, *Wysko Investment Co. v. Great American Bank*⁹ and *In re Delaware River Stevedores, Inc.*¹⁰ the courts used their powers under § 105 of the Code—which allows the bankruptcy court to issue injunctions that are “necessary or appropriate to carry out the provisions of [the Code]”¹¹—to enjoin payment on letters of credit. In both cases a provision in the letter of credit allowed the beneficiary to draw upon the letter of credit in the event of the account party's bankruptcy,¹² although the beneficiary in *Delaware River Stevedores* claimed that it requested the draw because of the account party's failure to make payments.¹³ In *Wysko*, the district court upheld the bankruptcy court's finding that the injunction against payment of the letter of credit was necessary for reorganization,¹⁴ relying on cases that permitted injunctions against third

teeing payment of revenue and development bonds, see *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*, 123 B.R. 104 (Bankr. S.D. Fla.), vacated, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991); *Diamond Mach. Co. v. Casco N. Bank (In re Diamond Mach. Co.)*, 95 B.R. 255 (Bankr. D. Me. 1988).

5. See generally *American Bank v. Leasing Serv. Corp. (In re Air Conditioning, Inc.)*, 845 F.2d 293 (11th Cir.), cert. denied, 488 U.S. 993 (1988); *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586 (5th Cir. 1987), *reh'g granted*, 835 F.2d 584 (5th Cir. 1988) (per curiam); *Prime Motor Inns, Inc.*, 123 B.R. 104; *Page v. First Nat'l Bank (In re Page)*, 18 B.R. 713 (D.D.C. 1982).

6. See U.C.C. § 5-102 (1990).

7. See 11 U.S.C. §§ 101-1330 (1988).

8. Compare *Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146 (D. Ariz. 1991) (granting injunction) and *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*, 130 B.R. 610 (S.D. Fla. 1991) (granting injunction) and *In re Delaware River Stevedores, Inc.*, 129 B.R. 38 (Bankr. E.D. Pa. 1991) (granting injunction) with *Zenith Labs. v. Security Pac. Nat'l Trust Co. (In re Zenith Labs., Inc.)*, 104 B.R. 667 (Bankr. D.N.J. 1989) (denying injunction) and *Diamond Mach. Co.*, 95 B.R. 255 (denying injunction).

9. 131 B.R. 146. In *Wysko*, the debtor obtained a letter of credit to secure its obligation to purchase an apartment complex. *Id.* at 146. Upon the debtor's bankruptcy filing, the beneficiary sought to draw upon the letter. *Id.* The debtor sought to substitute a certificate of deposit as security for its obligation to the beneficiary. *Id.*

10. 129 B.R. 38. In *Delaware River Stevedores*, the letter of credit was issued to secure the debtor's obligations as a self-insurer in the Department of Labor's Workmen's Compensation Program. *Id.* at 39.

11. 11 U.S.C. § 105(a) (1988).

12. *Delaware River Stevedores*, 129 B.R. at 39; *Wysko*, 131 B.R. at 146.

13. *Delaware River Stevedores*, 129 B.R. at 41.

14. *Wysko*, 131 B.R. at 147.

parties when "unusual facts" were present.¹⁵ In *Delaware River Stevedores*, the court granted a conditional stay pending a showing that payment on the letter of credit would cause irreparable harm to the estate.¹⁶

Cases such as *Wysko* and *Delaware River Stevedores* necessitate an analysis of the sometimes conflicting policies of the Bankruptcy Code and letter of credit law: Chapter 11's primary goals are equal treatment of similarly situated creditors and rehabilitation of the debtor, and the governing policy of letter of credit law is embodied in the independence principle.¹⁷

The conflicts between the UCC, as adopted by the various states, and federal law have long been recognized by various commentators.¹⁸ Issues have arisen under the Bankruptcy Code that were virtually unknown in 1978, when the Code was enacted. Issues such as leveraged buyouts, the integration of the global economy, and environmental problems have prompted Congress to propose the creation of a National Bankruptcy Review Commission to study problems related to the Code.¹⁹ The growth in standby letter of credit use is undoubtedly among the commercial realities not anticipated by Congress in drafting the Code. From 1950 to 1990, the dollar amount of letters of credit outstanding in the United States grew from one-half billion dollars to two hundred billion dollars, due in part to the development and acceptance of the standby letter of credit.²⁰ Therefore, those responsible for revising

15. The court relied on *Oberg v. Aetna Casualty & Surety Co. (In re A.H. Robins Co.)*, 828 F.2d 1023 (4th Cir. 1987), cert. denied, 485 U.S. 969 (1988). In *Oberg* appellants representing over 4000 Dalkon Shield claimants sought to sue Robins's insurer, Aetna, during the bankruptcy case. *Id.* at 1024. The court stayed the suits, invoking § 105, finding that Aetna would have to involve the officers, directors, and employees of Robins, which would exhaust their energies and thus interfere with Robins's reorganization. *Id.* at 1025-26.

16. 129 B.R. at 43.

17. The paramount goal of Chapter 11 of the Bankruptcy Code is rehabilitation of the debtor. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1984). The governing policy of letter of credit law is the independence principle, under which letters of credit are considered independent of the underlying transaction. *Tudor Dev. Group v. United States Fidelity & Guarantee Co.*, 968 F.2d 357, 366 (3d Cir. 1992). Strict adherents to the independence principle believe that an account party seeking to enjoin payment of a letter of credit should only succeed on the merits when the documents are defective on their face or when there is fraud or forgery. *DOLAN*, *supra* note 4, ¶ 11.04, at 11-30.

18. See, e.g., Charles W. Mooney, Jr., *Introduction to the Uniform Commercial Code Annual Survey: Some Observations on the Past, Present, and Future of the U.C.C.*, 41 BUS. LAW. 1343 (1986); E. Hunter Taylor, Jr., *Foreword: Federalism or Uniformity of Commercial Law*, 11 RUT.-CAM. L.J. 527 (1980).

19. 139 CONG. REC. S2626 (daily ed. Mar. 10, 1993) (statement of Sen. Grassley).

20. James E. Byrne, *Present Problems with U.C.C. Article 5, Preamble to an Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521, 1531 (1990).

the UCC and the Code should take this opportunity to harmonize the Code and the independence principle.

This Article examines bankruptcy and letter of credit policies to determine whether it is ever appropriate for a court to enjoin payment on a letter of credit because of the account party's bankruptcy.²¹ First, this Article disputes the notion that when an issuer pays on a letter of credit it violates the Code's prohibition of ipso facto clauses,²² and suggests that the Bankruptcy Code should be revised to specifically exclude letter of credit transactions from the prohibition of ipso facto clauses. Then, this Article shows that when courts considering whether to enjoin payment of letters of credit apply the four factors of the traditional preliminary injunction test,²³ they should never find it permissible to enjoin payment of letters of credit in bankruptcy. Finally, this Article concludes that the Code should be revised to prohibit injunctions against draws on letters of credit.²⁴

II. THE INDEPENDENCE PRINCIPLE

The independence principle distinguishes letters of credit from other payment devices, such as guarantees and surety contracts. A letter of credit transaction consists of three separate contracts: (1) the letter of credit from the issuer—often a bank—to the beneficiary, under which the issuer promises to pay the beneficiary upon presentation of specified documents;²⁵ (2) the underlying contract between the beneficiary and the

21. Traditionally, courts have refused to enjoin payment on letters of credit in the absence of fraud. *See United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 360 N.E.2d 943, 948 (N.Y. 1976); *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct. 1941); *Intraworld Indus. v. Girard Trust Bank*, 336 A.2d 316 (Pa. 1975). Section 5-114(2) of the Uniform Commercial Code (UCC) permits a court of appropriate jurisdiction to enjoin an issuer from honoring a letter of credit if the letter is forged or fraudulent or if there is "fraud in the transaction."

22. The Code prohibits the termination or modification of an executory contract of the debtor based solely upon the debtor's bankruptcy filing. 11 U.S.C. § 365(e)(1) (1988).

23. The four factors of the preliminary injunction test are: (1) possibility of irreparable harm to the debtor's estate; (2) likelihood of success on the merits; (3) whether the possible harm to the estate outweighs the possible harm to the beneficiary; and (4) the public interest. DAN B. DOBBS, *LAW OF REMEDIES* 187-88 (2d ed. 1993). *See also e.g., In re Delaware River Stevedores, Inc.*, 129 B.R. 38, 42 (Bankr. E.D. Pa. 1991); *Dore & Assocs. Contracting, Inc. v. American Druggists' Ins. Co. (In re Dore & Assocs. Contracting, Inc.)*, 54 B.R. 353, 357 (Bankr. W.D. Wis. 1985); *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 21 B.R. 777, 779 (Bankr. D.N.M.), *aff'd*, 25 B.R. 1018 (D.N.M. 1982).

24. An exception to this policy would arise when the letter of credit is issued on account of an antecedent debt within the preference period. *See infra* notes 65-72 and accompanying text.

25. In order to receive payment, the beneficiary under a standby letter of credit must certify to the issuing bank that his or her obligor, the account party, has not performed. DOLAN, *supra* note 4, ¶ 1.04.

account party, under which the account party promises some performance to the beneficiary; and (3) the reimbursement agreement between the account party and the issuer, under which the account party promises to repay the issuer if the issuer is required to pay under the letter of credit.²⁶ By operation of the independence principle, if the beneficiary presents documents to the issuer that conform to the requirements of the letter of credit, the issuer may not refer to the underlying contract between its customer and the beneficiary to determine whether to honor demand for payment.²⁷

The risk of an account party's inability to pay is the very risk the beneficiary seeks to avoid by requesting a letter of credit. A letter of credit permits a beneficiary to substitute the known and secure credit of an issuing bank for the unknown and perhaps risky credit of an account party.²⁸ A letter of credit permits a bank or other issuer that is familiar with an account party's financial strength to substitute its evaluation of the account party for the beneficiary's evaluation.²⁹ Consequently, a letter of credit shifts the risk of nonpayment from the beneficiary to the issuer. Thus arises the problem of letters of credit in the bankruptcy context: If an account party files a bankruptcy petition after an issuer issues a letter of credit, but before the beneficiary draws upon the letter of credit, the issuer must honor the beneficiary's draft even though the account party might not be able to pay the issuer.

Both the UCC and the Uniform Customs and Practices for Documentary Credits (UCP) codify the independence principle. The UCC, in section 5-109, relieves an issuer from liability for performance of the underlying contract and for lack of knowledge of particular trade usages.³⁰ Section 5-114(1) of the UCC requires an issuer to honor demands for payment that comply with the terms of the relevant letter of credit regardless of whether the goods or documents conform to the underlying

26. *Id.* ¶ 2.01.

27. The issuer must pay the beneficiary even when the beneficiary has nonfraudulently breached the underlying contract. *Jupiter Orrington Corp. v. Zweifel*, 469 N.E.2d 590, 592 (Ill. App. Ct. 1984).

28. *See Diamond Mach. Co. v. Casco N. Bank (In re Diamond Mach. Co.)*, 95 B.R. 255, 258 (Bankr. D. Me. 1988). The independence principle furthers the original purpose of letters of credit. Merchants originally used letters of credit as a method of reducing the uncertainties that result when a seller sells goods in a foreign land. *See New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 378 A.2d 562, 565 (Conn. 1977).

29. DOLAN, *supra* note 4, ¶ 3.07[2].

30. U.C.C. § 5-109 (1990) states:

contract between the account party and the beneficiary.³¹ The UCP states the independence principle explicitly in Article 3: Letters of credit, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the credit."³² The drafters of the proposed revised Article 5 have suggested the independence principle be explicitly defined in the black letter of Article 5, thus codifying the primacy of the independence principle to letter of credit law.³³

The independence principle gives the letter of credit a special place in the world of commercial financing, a place that letters of credit have occupied since at least the seventeenth century.³⁴ The letter of credit is an economical and practical financing device because the issuer's receipt, examination, and payment of the documents accompanying a draft can be achieved in a standardized and inexpensive manner.³⁵ A banker should be able to sit at a desk and determine, solely by looking at papers, whether or not the bank must make payment. Bankers, or other issuers,

(1) An issuer's obligation to its customer includes good faith and observance of any general banking usage but unless otherwise agreed does not include liability or responsibility

(a) for performance of the underlying contract for sale or other transaction between the customer and the beneficiary; or

(b) for any act or omission of any person other than itself or its own branch or for loss or destruction of a draft, demand or document in transit or in the possession of others; or

(c) based on knowledge or lack of knowledge of any usage or any particular trade.

31. U.C.C. § 5-114(1) (1990) provides:

An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.

32. UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS art. 3 (1983) (UCP). This is known as UCP 400. In January, 1994, a revised UCP, UCP 500, will take effect. See *ABA Experts Provide Update on UCP, UCC, Uncitral Projects*, 61 Banking Rep. (BNA) No. 8, at 335 (Aug. 30, 1993).

33. The January 29, 1993 draft of Article 5 defines the independence principle by stating that "[t]he duties of the issuer are independent of the performance of [the underlying] contracts," and that the independence principle is a central part of letter of credit law. *L/C Trends*, *supra* note 1, at 37.

34. DOLAN, *supra* note 4, ¶ 3.02. Some have traced the use of letters of credit to even earlier times. See, e.g., Boris Kozolchik, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 AM. J. COMP. L. 395 (1965) (tracing use of letters of credit to 12th century).

35. *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust*, 378 A.2d 562, 566 (Conn. 1977).

are not permitted to go into the field and determine whether the underlying contract has been performed.³⁶ The UCP sets forth this aspect of the independence principle by stating, in Article 4: "In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate."³⁷ The independence principle thus assures letter of credit beneficiaries prompt payment, and any delay in payment will diminish the benefit of the letter of credit as a commercial device.³⁸ Letters of credit are characterized by this prompt payment feature, which allows payment to be made after examining documents at a bank officer's desk.³⁹ One advantage of a letter of credit is that the beneficiary can rely on assured, prompt payment from a solvent party, accompanied by the expectation that there will be a minimum of litigation and judicial interference.⁴⁰ The independence principle is thus at odds with two major components of the Code: the concept that all creditors should be treated without preference,⁴¹ and the automatic stay of § 362, which halts all actions against the debtor and property of the estate while the bankruptcy case is pending.

Debtors have often argued that courts should use § 105 of the Code to extend the automatic stay to letters of credit. Section 105 allows bankruptcy judges to take any action "necessary or appropriate to carry out the provisions" of the Code.⁴² Courts and commentators differ as to the scope of § 105. Some favor a broad reading, believing that certain goals of the Code are implied but not stated in the statutory language, and that § 105 should give bankruptcy courts authority to fill in the gaps left by

36. WHITE & SUMMERS, *supra* note 4, § 19-2.

37. UCP, *supra* note 32, art. 4.

38. DOLAN, *supra* note 4, ¶ 3.07[7].

39. *Id.* ¶ 2.10[1].

40. *New York Life Ins. Co.*, 378 A.2d at 566. Although standby letters of credit are used to guarantee an account party's obligations to a beneficiary, it is essential to distinguish standby letters of credit from guarantees. One major difference between the two is that, under a guarantee, the guarantor's obligation to the creditor-beneficiary is secondary—that is, it depends upon the existence of an obligation on the part of the principal/account party—while under a letter of credit, the issuer's obligation to the beneficiary is primary. Thus, while a guarantor can assert any defenses that a principal has against a creditor, a letter of credit issuer may not. WHITE & SUMMERS, *supra* note 4, § 19-2; see also *New York Life Ins. Co.*, 378 A.2d at 565. In addition, although under a guarantee, the guarantor's obligation cannot mature until the principal has actually defaulted, actual default is irrelevant to an issuer's obligations under a letter of credit—the issuer must make payment upon the proper presentation of documents. WHITE & SUMMERS, *supra* note 4, § 19-2. Thus, the determination of a guarantor's liability under a guarantee requires a lengthy, complicated, and costly examination of the principal obligor's conduct; the determination of an issuer's liability upon a letter of credit does not.

41. See *infra* notes 48-74 and accompanying text.

42. 11 U.S.C. § 105 (1988).

the statutory language.⁴³ Others believe that § 105 is not a broad writ, that it should be narrowly construed, and that an exercise of § 105 power should be tied to another Code section and not merely to a general bankruptcy concept or objective.⁴⁴

Debtors seeking to use § 105 to enjoin payment on letters of credit rely on it because letters of credit are not protected by the Code's automatic stay provisions. Litigants have asked courts to use § 105 to grant various types of relief. In most cases, a party requests an injunction in proceedings against a nondebtor party who is not protected by the automatic stay. These cases include those in which a nondebtor partner or corporate officer of a debtor seeks to enjoin litigation against him- or herself, and those in which a guarantor of the debtor's debt seeks to enjoin enforcement of the guarantee.⁴⁵ Additionally, courts have addressed the applicability of § 105 to other forms of relief, such as using the section to allow several debtors to consolidate their plans of reorganization,⁴⁶ or relying on it as a basis for dismissing a Chapter 7 case.⁴⁷

III. RECENT CASE LAW REGARDING LETTERS OF CREDIT IN BANKRUPTCY

The controversy surrounding the treatment of letters of credit in bankruptcy began when the court in *Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.)* enjoined payment on three letters of credit, finding that payment of the letters of credit issued for the account of the debtor

43. 2 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 105.01[3] (Lawrence P. King et al. eds., 15th ed. 1993).

44. *Id.* The court in *Sinkow v. Latimer* stated that "invocation of § 105(a) should be reserved for a truly 'extraordinary set of circumstances'. . . . It is not to be employed as a loose cannon." 82 B.R. 354, 364 (Bankr. E.D. Pa. 1988) (citations omitted).

45. See, e.g., *University Medical Ctr. v. American Sterilizer Co. (In re University Medical Ctr.)*, 82 B.R. 754 (Bankr. E.D. Pa. 1988) (refusing to enjoin medical malpractice suits against debtor-partnership's partners because all claims would be covered by insurance and suits would not demand much of partners' time); *Kasual Kreation, Inc. v. Heller Fin., Inc. (In re Kasual Kreation, Inc.)*, 54 B.R. 915 (Bankr. S.D. Fla. 1985) (enjoining actions against guarantors of corporate debt when guarantors were officers of corporation and their time would be needed to operate debtor's business during holiday season); *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 21 B.R. 777 (Bankr. D.N.M.), *aff'd*, 25 B.R. 1018 (D.N.M. 1982) (enjoining enforcement of state court judgment against debtor's president who guaranteed loan to debtor because president was going to contribute personal assets to debtor to effect bankruptcy plan and because enforcing judgment might detrimentally pressure debtor).

46. *Bruce Energy Centre, Ltd. v. Orfa Corp. (In re Orfa Corp.)*, 129 B.R. 404 (Bankr. E.D. Pa. 1991).

47. *Sinkow*, 82 B.R. at 364.

would result in preferential treatment of the creditor-beneficiaries.⁴⁸ Southeast Bank issued the letters of credit on behalf of Twist Cap in December 1977, June 1978, and March 1979.⁴⁹ In August 1979 Twist Cap filed a petition for relief under Chapter XI of the Bankruptcy Act and sought an order restraining Southeast Bank from honoring the letters of credit.⁵⁰ In granting Twist Cap's request for an injunction, the court stated that

to permit these two unsecured creditors to receive a payment, possibly in full, on the pre-petition indebtedness owed to them by the debtor would amount to an impermissible preferential treatment of these two unsecured creditors which is contrary to the scheme of Chapter XI and would certainly be counter-productive to the debtor's efforts to obtain rehabilitation.⁵¹

The court in *Twist Cap* failed to recognize the special place of letters of credit in the business world, and also failed to consider the possibility of any harm to the beneficiary or the public interest.

The *Twist Cap* case was almost universally criticized for throwing into doubt the validity of a useful commercial financing device.⁵² Courts in many subsequent cases refused to enjoin payment of letters of credit because enjoining payment would "frustrate the commercial purposes of letters of credit to the detriment of financial institutions as well as their customers."⁵³

In refusing to enjoin payment of a letter of credit, the court in *Page Associates v. First National Bank (In re Page)* respected the purpose of

48. 1 B.R. 284, 285 (Bankr. M.D. Fla. 1979). In *Twist Cap*, the court granted injunctive relief to the debtor under the predecessor to § 105 of the Code, § 2(a)(15) of the Bankruptcy Act of 1898. *Id.* at 286.

49. *Id.* at 285.

50. *Id.*

51. *Id.*

52. See Douglas G. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130 (1982). The *Twist Cap* case disrupted the practice of issuing commercial paper backed by standby letters of credit because, as a result of *Twist Cap*, Standard and Poor's refused to rate paper of that type. *Counsel's Corner: Letter of Credit Collateral—A Spur to the Wary*, 98 BANKING L.J. 579 (1981).

53. *Page Assocs. v. First Nat'l Bank (In re Page)*, 18 B.R. 713, 717 (D.D.C. 1982); see also *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 590 (5th Cir. 1987), *reh'g granted*, 835 F.2d 584 (5th Cir. 1988) (stating that independence is cornerstone of letter of credit law); *Insurance Co. of N. Am. v. Heritage Bank*, 595 F.2d 171, 175-76 (3d Cir. 1979) (finding that letters of credit have grown and flourished because of certainty they provide); *Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank*, 571 F.2d 871, 874 (5th Cir. 1978) (allowing enjoinder of payment would make letters of credit lose value as guarantee of payment); *Armstrong v. FNB Fin. Co. (In re Clothes, Inc.)*, 35 B.R. 487, 489 (Bankr. D.N.D. 1983) (permitting payment of letter of credit and stating that following *Twist Cap* "would be wholly contrary to long established commercial law principles").

standby letters of credit—the intended substitution of a bank for its less credit-worthy customer—and held that if an injunction were to issue, then the letter of credit would become a dubious device for securing credit.⁵⁴ The court denied the injunction on several important grounds. First, cashing the letter of credit would not divest the estate of property because neither the letter of credit nor its proceeds are property of the estate under the Code.⁵⁵ In issuing a letter of credit, a bank commits to pay a beneficiary out of its own assets, not the assets of its customer.

Second, the district court in *Page* rejected the bankruptcy court's finding that cashing the letter of credit would violate the automatic stay as an act to "create, perfect or enforce" a lien in the property securing the debtor's obligation to indemnify the bank.⁵⁶ According to the *Page* court, cashing a letter of credit is not an act to enforce a lien, because, although the bank will have a claim against the debtor, that claim will be subject to the automatic stay.⁵⁷ Although cashing a letter of credit gives rise to a bank's claim against the debtor pursuant to the reimbursement agreement,⁵⁸ that claim would not divest the estate of any property, as enforcement of that claim would be subject to the automatic stay.⁵⁹ The court also held that cashing the letter of credit did not constitute a postpetition transfer of property under § 549 of the Code.⁶⁰

However, the *Page* court held out the possibility that an injunction might, in certain circumstances, be appropriate. The debtor contended that funding of the letter of credit would affect the filing of the debtor's reorganization plan.⁶¹ Although the court recognized the broad power

54. *Page*, 18 B.R. at 717. The bankruptcy court in *Page* had granted the debtor's request for an injunction. *Id.* at 714; see also *Planes, Inc. v. Fairchild Aircraft Corp. (In re Planes, Inc.)*, 29 B.R. 370, 371 (Bankr. N.D. Ga. 1983) (refusing to issue injunction against payment of letter of credit because doing so would seriously impair important commercial function of letters of credit).

55. A debtor's bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1988).

56. *Page*, 18 B.R. at 717.

57. *Id.* at 716.

58. The issuing bank has a contingent claim against the account party debtor at the time the account party debtor signs the reimbursement agreement. However, the bank gains the immediate right to payment of that claim at the time that the bank pays on the letter of credit. U.C.C. § 5-114(3) (1988) ("Unless 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 . . .").

59. 11 U.S.C. § 362(a)(4) (1988) provides that filing of a petition operates as a stay of "any act to create, perfect or enforce any lien against property of the estate."

60. *Page*, 18 B.R. at 716. The Code, in § 549, provides that a trustee may avoid a transfer of property of the estate made "after the commencement of the case" and that is either unauthorized by the court or is authorized under § 303(f) or § 542(c). 11 U.S.C. § 549 (1988).

61. *Page*, 18 B.R. at 717.

of the bankruptcy court to “do whatever is necessary to aid its jurisdiction,” the court found no evidence that an injunction would aid the preparation of a successful plan.⁶² Here, the court found that since the bank would be subject to the automatic stay, the debtor would be provided adequate breathing space to attempt to work out its financial affairs as intended by the Code.⁶³ To the extent the bank’s liens constrain the debtor’s use of its property in continuing its business or rearranging its affairs, this constraint would be the same whether or not the letter of credit was cashed.⁶⁴ However, while opening the door to the possibility of injunctive relief, the *Page* court failed to provide any guidance as to whether or when an injunction of a letter of credit would be appropriate.

Courts have routinely refused, however, to allow creditors to secure existing unsecured debts with secured letters of credit on the eve of bankruptcy. The problem of the letter of credit as a preferential transfer was addressed in *Kellogg v. Blue Quail (In re Compton Corp.)*⁶⁵ and *American Bank v. Leasing Service Corp. (In re Air Conditioning, Inc.)*.⁶⁶ In both cases the court allowed the bankruptcy trustee to recover the property transferred—the collateral securing payment of the letter of credit.⁶⁷ Both courts held that such a transfer made within ninety days of a debtor’s bankruptcy filing was a transfer “for the benefit of a creditor” and was thus a voidable preference under § 547(b) of the Code.⁶⁸

In *Kellogg*, the court rejected *Twist Cap* by stating that a court cannot enjoin payment of funds under a letter of credit because such a pay-

62. *Id.* (quoting 2 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY MANUAL ¶ 105.02, at 105-4 (Lawrence P. King et al. eds., 3d ed. 1993)).

63. *Id.*

64. *Id.*

65. 831 F.2d 586 (5th Cir. 1987), *reh’g granted*, 835 F.2d 584 (5th Cir. 1988) (per curiam).

66. 845 F.2d 293 (11th Cir.), *cert. denied*, 488 U.S. 993 (1988).

67. *Id.* at 299.

68. 11 U.S.C. § 547(b) (1988) allows a trustee in bankruptcy to avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under Chapter 7 of [the Code];

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of [the Code].

Id.

ment is not a transfer of a debtor's property.⁶⁹ The trustee in *Kellogg*, however, was asking to set aside the transfer of the *increased* collateral.⁷⁰ The collateral pledged as security for the letter of credit is property of the estate.⁷¹ The Fifth Circuit ordered Blue Quail, the beneficiary of the letter of credit, to return the value of the transferred collateral to the estate because the letter of credit was issued on account of an antecedent debt on the eve of bankruptcy.⁷² The court felt that its holding would not affect the strength of the proper use of the letter of credit.⁷³ The court in *American Bank* followed suit, again allowing the letter of credit to be drawn upon, but ordering the collateral transferred to be returned to the trustee.⁷⁴

*Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*⁷⁵ reopened the dialogue on the sanctity of letters of credit. There, the debtor, Prime Motor Inns, had financed the cost of constructing several hotels through the issuance of industrial revenue bonds through the New Jersey Economic Development Authority.⁷⁶ The bonds were secured by letters of credit issued on Prime Motor Inns' account to the indenture trustee. The trust indentures executed in connection with the bonds provided that the debtor's bankruptcy would constitute an event of default entitling the beneficiary to draw.⁷⁷ The indenture trustee admitted that the debtor's bankruptcy filing constituted the only default. The bankruptcy court made much of this fact in granting the injunction.⁷⁸ The district court, in reversing the bankruptcy court, found that the draw did not violate the anti-*ipso facto* provisions of the Code and additionally found that it would be in the public interest to allow the draw.⁷⁹ The court found that enjoining payment would de-

69. *Kellogg*, 831 F.2d at 589.

70. *Id.*

71. *Id.* at 590.

72. *Id.* at 596.

73. *Id.* In *Kellogg*, the debtor induced MBank to issue a letter of credit for the benefit of one of the debtor's suppliers one day before an involuntary bankruptcy petition was filed against the debtor. *Id.* at 589.

74. *American Bank*, 845 F.2d at 298-99. In *American Bank*, the debtor induced American Bank of Martin County to issue a letter of credit in favor of one of the debtor's equipment lessors within six weeks before debtor's Chapter 11 filing. *Id.* at 295.

75. 123 B.R. 104 (Bankr. S.D. Fla.), *vacated*, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991).

76. *Id.* at 105.

77. *Id.* at 107.

78. *Id.* at 111. The court applied the injunction test and concluded that Prime Motor Inns would most likely succeed on the merits because its default would not be valid under the *ipso facto* prohibition. The court gave little weight to the fact that the debtor was not a party to the Trust Indenture. *Id.* at 108.

79. *Id.* at 110-11.

feat the intended purpose of letters of credit: to shift the risk from the beneficiaries—bondholders—to the issuers—banks.⁸⁰

IV. A PROPOSED POLICY FOR TREATMENT OF LETTERS OF CREDIT IN BANKRUPTCY

A. *Prohibition of Ipso Facto Clauses*

A typical standby letter of credit is payable upon the beneficiary's certification to the issuer that the account party has defaulted in some obligation running from the account party to the beneficiary.⁸¹ Often, the agreement obligating the account party to the beneficiary will provide that the account party's bankruptcy is an event of default.⁸² This scenario, under which the account party/debtor's bankruptcy filing triggers the draw on the letter of credit, leads some debtors to argue that the draw violates the Code's invalidation of ipso facto clauses.⁸³ Section 365(e)(1) of the Code invalidates ipso facto clauses; that is, it prohibits the termination or modification of an executory contract of the debtor solely because of the commencement of a bankruptcy case.⁸⁴ In addition, the Code prohibits forfeiture of property of the estate merely because of a bankruptcy filing.⁸⁵ Since the Code provides no definition of "executory contract,"⁸⁶ courts have grappled with the issue of whether a bankruptcy default should trigger payment of a letter of credit.⁸⁷ Draws on letters of credit should be specifically exempted from § 365(e)(1) for the following reasons: the letter of credit is not a contract of the debtor; the reimbursement agreement, providing for the letter of credit, falls within the "financial accommodation" exception to § 365(e);⁸⁸ and, for purposes of § 365(e), letters of credit should be treated like guarantees and surety bonds, both of which can be enforced following a debtor's bankruptcy.⁸⁹

80. *Id.* at 104.

81. See U.C.C. § 5-114 (1990). For a discussion of issuer's duty to pay, see DOLAN, *supra* note 4, ¶ 7.02.

82. See, e.g., *Prime Motor Inns*, 123 B.R. at 107.

83. See *id.* at 104; *Zenith Labs. v. Security Pac. Nat'l Trust Co. (In re Zenith Labs., Inc.)*, 104 B.R. 667 (Bankr. D.N.J. 1989).

84. 11 U.S.C. § 365(e)(1) (1988).

85. *Id.* § 541(c) (1988).

86. The legislative history to the Code gives some guidance, stating that the term includes contracts in which performance remains due to some extent on both sides. H.R. REP. NO. 595, 95th Cong., 1st Sess. 347 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 6303-04.

87. See *Prime Motor Inns*, 123 B.R. at 108; *Zenith Labs.*, 104 B.R. at 672.

88. 11 U.S.C. § 365(e)(2)(B) (1988).

89. *Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.)*, 49 B.R. 440 (Bankr. N.D. Iowa 1985); *Fintel v. Oregon (In re Fintel)*, 10 B.R. 50 (Bankr. D. Or. 1981);

Courts confronted with the anti-*ipso facto* argument in letter of credit cases are faced with a web of three contracts that make up a letter of credit transaction: (1) the underlying contract between the account party and the beneficiary; (2) the letter of credit obligation running from the issuer to the beneficiary; and (3) the reimbursement obligation of the account party to the issuer. Does § 365 apply to the letter of credit? Does it apply to the reimbursement agreement? Or, does § 365 apply to the underlying contract? The answer to the first two questions is a resounding "No!" A letter of credit is not a contract of the debtor. It is an obligation of an issuer to a beneficiary obligating the issuer to pay the beneficiary out of the issuer's own funds upon the occurrence of certain conditions. Therefore, § 365(e)'s prohibition against the termination of an executory contract of the debtor based solely upon the debtor's bankruptcy filing does not apply. In addition, since neither the letter of credit nor its proceeds are property of the debtor's estate, § 541(c), prohibiting forfeiture of estate property, does not apply.⁹⁰

A reading of the plain language of the Code shows why the *ipso facto* prohibition should not apply to the reimbursement agreement. Furthermore, an exception to the *ipso facto* prohibition allows modification or termination of a contract to "make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor," even if that contract is executory.⁹¹ Such contracts are exempted from § 365(e)(1) because a trustee is not permitted to assume an executory contract to make a loan to or for the benefit of the debtor, or to issue a security of the debtor.⁹² The legislative history of the Code also indicates that a trustee cannot assume letters of credit.⁹³

The legislative history of the Code gives some insight into the prohibition of *ipso facto* clauses and why this prohibition does not apply to agreements to make a loan. The operation of such a clause in nonloan situations will frequently hamper a debtor's reorganization efforts: for

Governmental Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc. (*In re Adana Mortgage Bankers, Inc.*), 12 B.R. 977 (Bankr. N.D. Ga. 1980).

90. Page Assocs. v. First Nat'l Bank (*In re Page*), 18 B.R. 713, 717 (D.D.C. 1982).

91. 11 U.S.C. § 365(e)(2)(B).

92. *Id.* § 365(c)(2) (1988). But see *In re Texaco*, where a Trust Indenture was considered executory because the debtor, in addition to paying the notes, was also obligated to maintain an office where the notes could be presented for payment, maintain a current list of security holders, and replace lost, mutilated, or destroyed securities. 73 B.R. 960, 964 (Bankr. S.D.N.Y. 1987). The Indenture Trustee was obligated to commence litigation under the indenture, file proofs of claim, give notice of default, and submit reports to noteholders. *Id.*

93. H.R. REP. NO. 595, *supra* note 86, at 347, reprinted in 1978 U.S.C.C.A.N. at 6304. There is nothing in the legislative history, however, to indicate whether the trustee is standing in the shoes of the account party, the issuer, or the beneficiary.

example, if a supply contract were to terminate upon the debtor's bankruptcy.⁹⁴ However, a bankruptcy filing accelerates all of a debtor's debts. Therefore, a contract to make a loan to or for the benefit of the debtor cannot be utilized to assist in a debtor's reorganization or liquidation.⁹⁵

This "financial accommodation" exception to the ipso facto prohibition has been held to apply only to agreements to provide future credit.⁹⁶ The reimbursement agreement, under which the issuer gives the letter of credit, is an agreement to provide credit for the benefit of an account party upon the presentation of specified documents and is therefore an agreement to provide future credit for the benefit of the debtor.⁹⁷ The trustee in bankruptcy cannot assume or reject this contract on the grounds that it is a loan contract. Therefore, the ipso facto prohibition in § 365 of the Code should be inapplicable to agreements to provide a letter of credit.

The question involving whether the underlying contract default should be subject to the anti-*ipso facto* provision is far more complicated. Parties seeking to enjoin payment of letters of credit will sometimes argue that the underlying contract default precipitating the draw was void because of the *ipso facto* prohibition.⁹⁸ Courts have yet to articulate a clear answer to this argument. In the cases involving public finance transactions, when the account party's bankruptcy filing triggers a draw on a letter of credit, the courts have addressed the *ipso facto* argument by holding that since the underlying contract is not a contract of the debtor, the underlying contract is not subject to § 365(e).⁹⁹ Unfortunately, this reasoning applies only to public finance transactions.

94. *Id.*

95. Such an assumption is prohibited by 11 U.S.C. § 365 (c)(2).

96. *Peninsula Int'l Corp. v. Citizens & Southern Int'l Bank (In re Peninsula Int'l Corp.)*, 19 B.R. 762, 764 (Bankr. S.D. Fla. 1982) (holding bankruptcy default invalid in agreement extending debtor's time to pay previous debt).

97. For an example of a reimbursement agreement, also known as an application agreement, see *DOLAN*, *supra* note 4, §§ A-75 to A-83.

98. *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*, 123 B.R. 104 (Bankr. S.D. Fla.), *vacated*, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991); *Zenith Labs. v. Security Pac. Nat'l Trust Co. (In re Zenith Labs., Inc.)*, 104 B.R. 667 (Bankr. D.N.J. 1989). In *Diamond Machine Co. v. Casco Northern Bank (In re Diamond Machine Co.)*, 95 B.R. 255, 257 (Bankr. D. Me. 1988), the debtor pointed out that its only default under its bond financing documents was a bankruptcy filing and further claimed that all of its payments were current. However, in requesting an injunction against payment of a letter of credit, the debtor did not ask the court to declare its default void under § 365(e). *Id.*

99. *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motors Inns, Inc.)*, 130 B.R. 610, 613 (S.D. Fla. 1991); *Zenith Labs.*, 104 B.R. at 672.

In public finance transactions, the debtor is not a party to the trust indenture, because the bonds are obligations of public authorities.¹⁰⁰ Typically, the debtor's bankruptcy filing will constitute an event of default under the trust indenture, entitling the trustee to draw upon the credit to pay the bonds. Courts therefore have found that no "contract of the debtor" was involved, and therefore that the draws did not violate the Code's prohibition of ipso facto clauses.¹⁰¹

Courts have applied the foregoing reasoning to deny injunctions in cases such as *Zenith Laboratories v. Security Pacific National Trust Co. (In re Zenith Laboratories, Inc.)*¹⁰² and *Prime Motor Inns v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*.¹⁰³ Both cases dealt with public financing arrangements under which the default that triggered the draw arose under a trust indenture to which the debtor was not a party. In *Zenith Laboratories* the debtor's bankruptcy constituted a default under a financing agreement between the debtor and the the New Jersey Economic Development Authority (EDA). The default, in turn, constituted a default under the trust indenture. The debtor's obligations under its financing agreements with the EDA were assigned to the indenture trustee,¹⁰⁴ as is typical in such arrangements. Therefore, it may be a stretch to reason, as the *Prime Motor Inns* and *Zenith Laboratories* courts did, that the ipso facto prohibition does not apply because the trust indenture is not a contract of the debtor. In addition, although such reasoning works in public finance cases, it does not provide a consistent policy for application in all letter of credit cases, as for instance, those in which the debtor is a party to the underlying agreement.¹⁰⁵

It is useful to look at cases involving guarantees and surety bonds to illustrate why § 365, applied to the underlying contract between the account party and the beneficiary, should not operate to support injunctions against payment of letters of credit. It is well-settled that a

100. In the typical municipal bond transaction, the public authority makes a loan of the bond proceeds to a developer who is the principal obligor. The developer obtains a letter of credit to guarantee repayment of the bonds.

101. *Prime Motor Inns*, 130 B.R. at 613; *Zenith Labs.*, 104 B.R. at 672. *Zenith Labs.* was argued under the Code's automatic stay provision. Its facts are similar to those in *Prime Motor Inns*.

102. 104 B.R. at 667.

103. 123 B.R. 104 (Bankr. S.D. Fla.), *vacated*, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991).

104. *Zenith Labs.*, 104 B.R. at 672.

105. *Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146 (D. Ariz. 1991) (involving debtor who entered into agreement to purchase apartment complex and obtained letter of credit to secure its obligation thereunder); *In re Delaware River Stevedores, Inc.*, 129 B.R. 38 (Bankr. E.D. Pa. 1991) (involving letter of credit issued to secure debtor's obligations under agreement with U.S. Department of Labor).

guarantee is a contract to make a financial accommodation for the benefit of the debtor.¹⁰⁶ Courts have recognized that although surety bonds are not the same as loan agreements, such bonds do obligate sureties to perform the debtor's financial obligations in the event that a debtor does not or cannot pay. As such, courts have held that surety bonds are financial accommodations for the purpose of § 365 of the Code.¹⁰⁷

A standby letter of credit performs the same function as a guarantee or surety bond, with the added benefit of prompt payment afforded by the independence principle. A letter of credit issuer is obligated to pay the beneficiary if the account party cannot or does not pay on its obligation to the beneficiary. The point is well-settled that a creditor may proceed against a guarantor or surety of the debtor if the debtor fails to perform its obligations for any reason, including bankruptcy.¹⁰⁸ Thus, it would be senseless to allow debtors to successfully argue that draws on letters of credit are prohibited by § 365(e) of the Code, while courts allow payments on guarantees and surety bonds.

An analysis of the *Wysko Investment Co. v. Great American Bank*¹⁰⁹ and *In re Delaware River Stevedores, Inc.*¹¹⁰ cases shows why the application of § 365(e)(1) to agreements to provide letters of credit defeats the purpose of letters of credit. In *Wysko*, the court enjoined payment on the letter of credit and allowed the debtor to substitute a certificate of deposit for the letter of credit.¹¹¹ The beneficiary, upon such substitution, lost its bargained-for protection, because any action by the beneficiary to obtain the proceeds of the certificate of deposit upon default by the account party-debtor would be subject to the automatic stay as an action to enforce a lien against property of the debtor.¹¹²

In *Delaware River Stevedores* the court did not need to address the ipso facto argument because the beneficiary claimed that it was the debtor's failure to make its worker's compensation payments—not the

106. *Governmental Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc. (In re Adana Mortgage Bankers, Inc.)*, 12 B.R. 977 (Bankr. N.D. Ga. 1980) (allowing GNMA to terminate its guarantee of mortgage banker's obligations under GNMA's mortgage-backed securities program upon mortgage banker's bankruptcy filing).

107. *Wegner Farms Co. v. Merchants Bonding Co. (In re Wegner Farms Co.)*, 49 B.R. 440 (Bankr. N.D. Iowa 1985).

108. *Fintel v. Oregon (In re Fintel)*, 10 B.R. 50, 52 (Bankr. D. Or. 1981) (involving surety bond); see also *In re Larmar Estates, Inc.*, 5 B.R. 328 (Bankr. E.D.N.Y. 1980) (involving guarantee).

109. 131 B.R. at 146.

110. 129 B.R. at 38.

111. *Wysko*, 131 B.R. at 146.

112. 11 U.S.C. § 362(a)(5) (1988).

debtor's bankruptcy—that led to the draw.¹¹³ The question thus arose whether the debtor could make the required payments while its bankruptcy case was pending.¹¹⁴ The court allowed the injunction pending a determination of whether the debtor could make the payments.¹¹⁵ The court thus defeated a prime goal of letters of credit, that of prompt payment. Even if bankruptcy were the only default, the Department of Labor bargained for prompt payment upon the debtor's bankruptcy. The court would not be able to provide an equal assurance of payment.

When ipso facto clauses are unenforceable, courts must be sensitive to the rights of the nondebtor party to the contract or lease. If the trustee in bankruptcy assumes a contract, the court must ensure that the trustee's performance under the contract will give the other contracting party the full benefit of its bargain.¹¹⁶ In the letter of credit context, the only way to give the beneficiary the benefit of its bargain is to recognize the shift of risk from the beneficiary to the issuer and to enforce the letter of credit.

The foregoing analysis shows a need to clarify the financial accommodation exception to § 365(e) of the Code. One way to provide a consistent policy for dealing with the ipso facto argument in letter of credit cases would be to provide an express exemption for letters of credit within § 365(e). Standby letters of credit are agreements to provide future credit for the benefit of an account party. It would be useful, therefore, to define "financial accommodation" to include letters of credit issued for the account of the debtor.

B. Injunction Test

Once the ipso facto argument is disposed of, an alternative argument can be made that the letter of credit should be enjoined because an injunction is necessary for the debtor's reorganization.¹¹⁷ Such an argument necessitates an analysis of the four-prong test for injunctive relief.

The UCC contemplates injunctions of letters of credit only in the event that a required document is forged or fraudulent or if there is fraud

113. *Delaware River Stevedores*, 129 B.R. at 42.

114. *Id.*

115. *Id.* at 44.

116. H.R. REP. NO. 595, *supra* note 86, at 347, reprinted in 1978 U.S.C.C.A.N. at 6304-05. If the trustee assumes an executory contract or lease of the debtor, the trustee must "provide[] adequate assurance of future performance under such contract or lease." 11 U.S.C. § 365(b)(1)(C) (1988).

117. *Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146, 147 (D. Ariz. 1991); *Page Assocs. v. First Nat'l Bank (In re Page)*, 18 B.R. 713, 717 (D.D.C. 1982); *Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.)*, 1 B.R. 284, 285 (Bankr. M.D. Fla. 1979).

in the transaction.¹¹⁸ Thus, if the UCC were the sole source of law there would be no injunctions issued merely on account of a party's bankruptcy. However, problems arise from the overlap of bankruptcy law. Courts have considered enjoining payment on letters in bankruptcy cases, using the same theory that they use in cases involving stays against other codebtors, such as insurance companies¹¹⁹ and guarantors.¹²⁰ The payment of the letter of credit would have a negative impact on the debtor's reorganization efforts. The analysis that follows shows that, although an injunction against some codebtors may be appropriate in bankruptcy cases, injunctions against letters of credit are not appropriate.

In determining whether to enjoin actions against a nondebtor under § 105 of the Code,¹²¹ courts have considered the following four factors: (1) whether the plaintiff will suffer irreparable injury if the injunction is not granted; (2) whether such injury outweighs the harm that granting injunctive relief would inflict on the defendant; (3) whether the plaintiff has exhibited a likelihood of success on the merits; and (4) whether the public interest will be served by granting the injunction.¹²² The following analysis shows that when courts consider these four factors in letter of credit cases, they should never find it permissible to enjoin letters of credit in bankruptcy.

1. Irreparable injury

In bankruptcy proceedings, courts have construed the irreparable injury requirement to mean that there is a danger of imminent, irreparable harm to the estate or the debtor's ability to reorganize.¹²³ In actions involving letters of credit, debtors have argued that the estate will suffer

118. U.C.C. § 5-114(2) (1989).

119. *Oberg v. Aetna Casualty & Sur. Co.* (*In re A.H. Robins Co.*), 828 F.2d 1023 (4th Cir. 1987), *cert. denied*, 485 U.S. 969 (1988).

120. *Lahman Mfg. Co. v. First Nat'l Bank* (*In re Lahman Mfg. Co.*), 33 B.R. 681 (Bankr. D.S.D. 1983).

121. The automatic stay provisions in § 362 are limited to actions against debtors. See generally Barry L. Zaretsky, *Co-Debtor Stays in Chapter 11 Bankruptcy*, 73 CORNELL L. REV. 213 (1988) (analyzing how courts have stayed actions against codebtors despite absence of explicit codebtor stay in Chapter 11).

122. *Diamond Mach. Co. v. Casco N. Bank* (*In re Diamond Mach. Co.*), 95 B.R. 255 (Bankr. D. Me. 1988); see also cases cited *supra* note 20.

123. *In re Monroe Well Serv., Inc.*, 67 B.R. 746, 754 (Bankr. E.D. Pa.), *modified and aff'd*, 69 B.R. 58 (E.D. Pa. 1986).

irreparable harm as a result of the high rate of interest payable on the reimbursement agreement.¹²⁴

Courts have held that there is the possibility of irreparable harm to a debtor's estate when the failure to grant the requested injunction would cause the debtor's business to cease operating.¹²⁵ In *In re Monroe Well Service, Inc.*, the debtor asked the court to enjoin creditors with materialmen's liens from enforcing those liens against property that was not property of the debtor's estate.¹²⁶ If the creditors were permitted to enforce their liens, the owners of the working interests in the oil wells would cease making monthly service payments to the debtor.¹²⁷ The debtor would thus cease servicing the wells, and the wells would cease being operational within thirty to ninety days.¹²⁸ The court recognized that the failure to grant an injunction would deprive the debtor of all of its operating income and would destroy any prospects for reorganization.¹²⁹ The court granted the injunction, noting that the failure to do so would cause irreparable harm to the debtor. In contrast, payment on a letter of credit would not stop a debtor's business, because any action by the issuer against the debtor would be subject to the automatic stay and the debtor would not be deprived of operating income.

Courts have also found irreparable harm where the continuation of actions against a party liable with the debtor would interfere with the efforts of the debtor's officers, directors, and employees to formulate and effect the plan of reorganization. *Oberg v. Aetna Casualty & Surety Co. (In re A.H. Robins Co.)*,¹³⁰ a case arising out of the A.H. Robins Co. bankruptcy, is the type of case where the failure to enjoin actions against a third party would result in unusual harm to the debtor's ability to reorganize. The court found such irreparable harm when over 4000 plaintiffs wished to sue Aetna, the debtor's insurer, for injuries resulting from the use of the Dalkon Shield.¹³¹ The court's holding was based on the fact that Aetna's defense would be that Robins, not Aetna, was responsible

124. *In re Delaware River Stevedores, Inc.*, 129 B.R. 38 (Bankr. E.D. Pa. 1991); *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*, 123 B.R. 104 (Bankr. S.D. Fla.), *vacated*, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991).

125. *Monroe Well Serv.*, 67 B.R. at 746.

126. *Id.* at 748.

127. *Id.* at 749.

128. *Id.*

129. *Id.* at 750.

130. *Oberg v. Aetna Casualty & Sur. Co. (In re A.H. Robins Co.)*, 828 F.2d 1023 (4th Cir. 1987), *cert. denied*, 485 U.S. 969 (1988).

131. *Id.* at 1025.

for the plaintiffs' injuries.¹³² If this were the case, Robins's officers, directors, and employees would be drawn into a massive lawsuit, which would demand a great deal of their time and interfere with Robins's reorganization.¹³³ However, in another case, the court held that officers and employees of a debtor will be required to testify in only two actions against the debtor's surety absent an injunction, the harm to the debtor's estate was not irreparable.¹³⁴ There is no comparable harm in the letter of credit context, because payment on the credit is immediate upon presentation of the required documents.

In cases where a solvent guarantor is the only source of reorganization funds and a continued action against the guarantor would deplete this source of funds,¹³⁵ or where a continued action against a third party could result in undue pressure on the debtor, courts have also found irreparable harm to the debtor's ability to reorganize.¹³⁶ The court in *First Federal Savings & Loan v. Pettit*¹³⁷ enjoined a home mortgagee's action against nonbankrupt codebtors where the nonbankrupt codebtors were the debtor's parents. The court found that the failure to enjoin such an action, where the third party was a close relative of the debtor, might place undue pressure on the bankrupt and ultimately affect the proposed reorganization.¹³⁸ Neither of the above two situations applies to letters of credit: the first because the issuer's funds would not be available for the debtor's reorganization, and the second because it is unlikely that an issuer could place undue influence on the debtor.

Debtors have, however, claimed irreparable injury arising from the higher rate of interest payable on the reimbursement agreement. The

132. *Id.* at 1025-26.

133. *Id.*

134. *Dore & Assocs. Contracting, Inc. v. American Druggists' Ins. Co. (In re Dore & Assocs. Contracting, Inc.)*, 54 B.R. 353, 361 (Bankr. W.D. Wis. 1985). In *Dore*, the city of Wausau, Wisconsin successfully lifted a preliminary injunction enjoining Wausau from suing on a surety bond issued for the debtor in connection with a construction project. *Id.* The court also found that the additional legal costs incurred by the debtor would not constitute irreparable harm, nor would the fact that the surety would be subrogated to Wausau's claim against the debtor's bankruptcy estate. *Id.* at 361-62.

135. *Lahman Mfg. Co. v. First Nat'l Bank (In re Lahman Mfg. Co.)*, 33 B.R. 681 (Bankr. D.S.D. 1983). In *Lahman*, the guarantor-president wanted to use debtor-owned real estate as collateral to finance debtor's reorganization effort. *Id.* at 683. The court found irreparable harm because an action against the guarantor would deplete this source of financing. *Id.*

136. *First Fed. Sav. & Loan v. Pettit*, 510 F. Supp. 226 (E.D. Ark. 1981).

137. *Id.*

138. *Id.* at 228.

bankruptcy court in *Prime Motor Inns*¹³⁹ enjoined payment on several letters of credit, finding, in part, the possibility of irreparable harm to the debtor because of the high rate of interest that the debtor would be required to pay under its reimbursement agreement.¹⁴⁰ The district court, in reversing the bankruptcy court, did not address whether payment of a higher rate of interest could constitute irreparable harm.¹⁴¹ In *Delaware River Stevedores*, the court declined to hold that a higher rate of interest would, in itself, cause irreparable harm to the debtor's estate. The debtor gave the letter of credit as security for the debtor's participation as a self-insurer in the United States Department of Labor's Workmen's Compensation Program.¹⁴² Upon the debtor's bankruptcy filing and failure to pay its insurance obligations, the Department of Labor attempted to draw on the letter.¹⁴³ The reimbursement agreement between the debtor and the issuer called for an interest rate of 11.25%.¹⁴⁴ In arguing that this higher interest rate would result in irreparable injury to the debtor, the debtor's chief executive officer testified that the additional debt—at the higher interest rate—would be a forty percent increase in the debtor's trade debt.¹⁴⁵ The court suggested that the debtor make a motion to pay its obligations directly during the course of the bankruptcy case, and extended the stay pending resolution of such a motion.¹⁴⁶ The court did not rule on whether paying a high rate of interest could constitute irreparable harm.

A high rate of interest payable on the reimbursement agreement should not be considered irreparable harm to the debtor. Under the Code, a secured creditor is entitled to postpetition interest on its claim.¹⁴⁷ Therefore, if the reimbursement agreement between an account party and its issuer is secured, the issuer should be entitled to the interest provided for under the reimbursement agreement, up to the value of the collateral securing the reimbursement agreement. The interest rate on

139. *Prime Motor Inns, Inc. v. First Fidelity Bank N.A.* N.J. (*In re Prime Motor Inns, Inc.*), 123 B.R. 104 (Bankr. S.D. Fla.), *vacated*, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991).

140. *Id.* at 106. The difference between the interest rate on the bonds and the interest rate on the letters of credit amounted to \$742,000 per year. *Id.*

141. *See Prime Motor Inns, Inc. v. First Fidelity Bank N.A.* N.J. (*In re Prime Motor Inns, Inc.*), 130 B.R. 610 (S.D. Fla. 1991). The court based its holding primarily on the fact that it did not believe that the bankruptcy court had jurisdiction over the matter.

142. *In re Delaware River Stevedores, Inc.*, 129 B.R. 38, 39 (Bankr. E.D. Pa. 1991).

143. *Id.*

144. *Id.* at 40.

145. *Id.*

146. *Id.* at 44. The debtor's good faith was in question, as it admitted that it filed a Chapter 11 petition in part to avoid its payments to the Department of Labor. *Id.*

147. 11 U.S.C. § 506(b) (1988).

the reimbursement agreement, however, is usually higher than the interest rate on the original obligation owed by the debtor-account party to the beneficiary. Courts have held that a creditor can be, but is not always, entitled to a higher, or "default," rate of interest after a bankruptcy filing.¹⁴⁸ Consequently, some courts have allowed creditors a postpetition interest rate as high as 38.53%,¹⁴⁹ while others have disallowed a twenty-five percent postpetition interest rate as a penalty.¹⁵⁰

A higher rate of interest does not per se constitute irreparable harm to the debtor's ability to reorganize. Courts will uphold a bargained-for, contractual default rate of interest unless equitable considerations demand otherwise.¹⁵¹ Courts evaluate the allowability of default rates of interest on a case-by-case basis. Courts tend to allow such rates if the debtor had an opportunity to bargain over the default rate,¹⁵² the rate is an industry standard,¹⁵³ and the creditor is oversecured.¹⁵⁴ Debtors have the right to bargain for the default rate of interest payable on the reimbursement agreement—on the underlying contract with the beneficiary, a debtor could bargain to provide security other than a letter of credit, thus obviating the need for a reimbursement agreement. Since such a default rate would only be payable to an oversecured issuer up to the value of its security, it is difficult to see the harm to the debtor's estate as irreparable: A secured letter of credit issuer would be treated like any other secured creditor.

Irreparable harm in the letter of credit context is unlikely. Although the interest rate on the reimbursement agreement will be higher than the interest rate on the underlying loan, higher default rates of interest are permissible in bankruptcy. The debtor will not be subject to any additional actions during the bankruptcy case because the issuing bank's actions against the account party will be stayed until the case is closed. Additionally, it is not likely that a bank could impose undue pressure on a debtor in the way that an insider or family member could.

148. Compare *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987) (enforcing 14.75% default rate of interest) with *In re W.S. Shepley & Co.*, 62 B.R. 271 (Bankr. N.D. Iowa 1986) (declining to enforce 12% default rate of interest because creditor's risk of nonpayment was small and since Chapter 11 plan provided for orderly liquidation).

149. *In re Whatley*, 134 B.R. 561 (Bankr. S.D. Miss. 1991).

150. *In re DWS Invs., Inc.*, 121 B.R. 845 (Bankr. C.D. Cal. 1990).

151. *Id.* at 849.

152. *Connecticut Gen. Life Ins. Co. v. Schaumburg Hotel Owners Ltd. Partnership (In re Schaumburg Hotel Owners Ltd. Partnership)*, 97 B.R. 943, 951 (Bankr. N.D. Ill. 1989); *Skyler Ridge*, 80 B.R. at 511.

153. *DWS Invs.*, 121 B.R. at 849.

154. *W.S. Shepley & Co.*, 62 B.R. at 278.

2. Balancing of harms

After evaluating the injury to the debtor and the debtor's estate, courts must balance that injury against the injury to other creditors if the injunction is granted. In the letter of credit context, the harm to the debtor that will arise from the issuer's payment on the letter of credit will be the high rate of interest the debtor will have to pay to the issuing bank.¹⁵⁵ Although a high rate of interest will deplete the debtor's estate, reducing payment to unsecured creditors, the Code specifically allows postpetition interest. Default rates of interest are allowable in bankruptcy.¹⁵⁶ The harm to the account party would be prevented by the automatic stay. In addition, postpetition interest is only allowed to secured creditors; thus, in all likelihood, the issuer of an unsecured letter of credit would not be able to collect the higher rate of interest.¹⁵⁷ A secured issuer could only collect interest at the default rate up to the value of its collateral; therefore, the harm to other creditors as a result of the draw would probably not be serious.

The creditor-beneficiary, however, loses the benefit of its bargain. In *Dore & Associates Contracting, Inc. v. American Druggists' Insurance Co. (In re Dore & Associates Contracting, Inc.)*,¹⁵⁸ a case in which the debtor attempted to enjoin payment on a surety bond, the court found that the injury to the city—with whom the debtor had entered into a site development contract—as a result of being enjoined from exercising its bargained-for right to sue on a surety bond, far outweighed the possible injury to the debtor from allowing the suit.¹⁵⁹ Many lenders will not lend without a letter of credit guaranteeing the borrower's indebtedness. Consequently, lenders commonly bargain for the right to draw on a letter of credit if the borrowers fail to perform. The risk of the borrower's bankruptcy is one of the risks that the lender is seeking to avoid.

In the municipal bond context, the losers are the general public, who are the bondholders. The bondholders are deprived of the bargain they made when they bought the bonds—that the credit of a bank would stand behind the credit of a municipality.¹⁶⁰

155. The debtor will have to pay this rate for all prepetition interest, and for postpetition interest if the bank's reimbursement is oversecured. 11 U.S.C. § 506(b) (1988); see *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235 (1989).

156. See *supra* notes 148-54 and accompanying text.

157. 11 U.S.C. §§ 502(b)(2), 506(b) (1988).

158. *Dore & Assocs. Contracting, Inc. v. American Druggists' Ins. Co. (In re Dore & Assocs. Contracting, Inc.)*, 54 B.R. 353 (Bankr. W.D. Wis. 1985).

159. *Id.*

160. See *Prime Motor Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motor Inns, Inc.)*, 130 B.R. 610, 614 (S.D. Fla. 1991).

3. Likelihood of success on the merits

Generally, likelihood of success on the merits of the case is a prerequisite to a preliminary injunction. In cases where courts have been asked to issue a § 105 injunction, the courts have held that the debtor has a likelihood of success on the merits when there is a reasonable likelihood of a successful reorganization.¹⁶¹ In *Monroe Well Service*¹⁶² the court found that this requirement was satisfied when the debtor had submitted its plan of reorganization and where all interested parties believed that there was a reasonable possibility of reorganization.¹⁶³ On the other hand, in *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, the debtor's plan was not yet due at the time the injunction was requested; therefore, the probability of a successful reorganization was speculative.¹⁶⁴ The court held that debtors are entitled to present a plan and thus enjoined an action against a guarantor until either the debtor failed to file a plan or its plan was not approved.¹⁶⁵

It seems that the probability of success on the merits cannot be determined without evaluating the seriousness of the harm arising from failure to grant an injunction. If the harm as a result of failure to enjoin is serious enough to impede the debtor's reorganization, then the court will likely favor reorganization, unless the public interest far outweighs the purpose served by granting an injunction. As this Article illustrates,¹⁶⁶ a great deal of public interest weighs in favor of upholding letters of credit.

4. The public interest

The fourth factor that courts look to in deciding whether or not to grant an injunction under § 105 is whether the public interest will be served by granting the injunction. Courts must weigh a prime goal of bankruptcy—preserving and protecting the assets of a debtor so that they may be distributed in time to all creditors without unfair preference¹⁶⁷—

161. *In re Monroe Well Serv., Inc.*, 67 B.R. 746, 752 (Bankr. E.D. Pa.), *modified and aff'd*, 69 B.R. 58 (E.D. Pa. 1986); *Dore*, 54 B.R. at 358; *Lahman Mfg. Co. v. First Nat'l Bank (In re Lahman Mfg. Co.)*, 33 B.R. 681, 684-85 (Bankr. D.S.D. 1983); *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 21 B.R. 777, 779 (Bankr. D.N.M.), *aff'd*, 25 B.R. 1018 (D.N.M. 1982).

162. 67 B.R. at 746.

163. *Id.* at 755.

164. *Otero Mills*, 21 B.R. at 779.

165. *Id.*

166. *See supra* part II.

167. *Penn Terra, Ltd. v. Department of Env'tl. Resources*, 733 F.2d 267, 269 (3d Cir. 1984).

against competing societal interests.¹⁶⁸ In the letter of credit context, the debtor will often argue that payment on the letter of credit will impede the debtor's reorganization by depleting assets of the estate.¹⁶⁹ Therefore, when deciding whether or not to enjoin payment of letters of credit, courts must weigh the goal of preserving the debtor's assets against the goal of upholding letters of credit as a unique commercial financing device.

In proceedings involving payment obligations that did not fall strictly into protected Code sections, the courts have held state environmental policies¹⁷⁰ and state criminal laws¹⁷¹ to be paramount to federal bankruptcy policy. Courts have held that environmental policies may supersede the Bankruptcy Code because of each state's strong interest in safeguarding the health, safety, and welfare of its citizens.¹⁷² They have also held that states should be able to fashion criminal penalties without interference from the Bankruptcy Code.¹⁷³

Established state policies, such as those regarding crimes and the environment, are not the only policies to which the Code must yield. Courts have construed the term "public interest" in a variety of ways. In *Lahman Manufacturing Co. v. First National Bank (In re Lahman Mfg.*

168. Certain conflicts between bankruptcy law and other societal interests are broadly resolved in the Code itself. The automatic stay provisions do not apply to the commencement or continuation of criminal actions against the debtor, to the collection of alimony, maintenance, or support from the debtor's property, or to actions to enforce a state's police power. 11 U.S.C. § 362(b) (1988). In addition, the Code excepts from discharge certain tax obligations, criminal penalties, alimony payments, student loan obligations, and debts arising from drunk driving accidents. *Id.* § 523 (1988).

169. *See Prime Motors Inns, Inc. v. First Fidelity Bank N.A. N.J. (In re Prime Motors Inns, Inc.)*, 123 B.R. 104 (Bankr. S.D. Fla.), *vacated*, 134 B.R. 445 (Bankr. S.D. Fla. 1990) (supplemental opinion), *rev'd*, 130 B.R. 610 (S.D. Fla. 1991).

170. *See, e.g., Penn Terra*, 733 F.2d 267.

171. *Kelly v. Robinson*, 479 U.S. 36 (1986).

172. In *Penn Terra*, a coal mining corporation filed a petition under Chapter 7 of the Code while it was under a state court order to correct violations of state environmental protection statutes. The Department of Environmental Resources argued that enforcement of the debtor's obligations was exempted from the stay as an exercise of the state's police power under § 362(b)(4). *Penn Terra*, 733 F.2d at 270. The debtor, *Penn Terra*, argued that enforcing its cleanup obligations would be a violation of the automatic stay as an enforcement of a money judgment under § 362(b)(5), and thus asked the court to interpret the term "money judgment" to include enforcement of a mandatory injunction requiring the debtor to spend money. *Id.* at 270-72.

173. In *Kelly*, the debtor, prior to filing her Chapter 7 petition, had pled guilty to larceny, and, as part of her sentence, was required to make restitution to the Connecticut Department of Adult Probation. *Kelly*, 479 U.S. at 38-39. The bankruptcy court granted the debtor a discharge. *Id.* at 39. This decision was reversed by the district court and reversed again by the Second Circuit. *Id.* at 42-43. The Supreme Court was thus faced with the question of whether this kind of a debt was dischargeable in bankruptcy. *Id.* at 38.

Co.),¹⁷⁴ the debtor was a farm implements manufacturer in a town with a population of 450.¹⁷⁵ The debtor was the largest employer in town.¹⁷⁶ The court found, therefore, that the public interest weighed in favor of the debtor's reorganization, and thus enjoined an action against the debtor's guarantor.¹⁷⁷

Of course, bankruptcy interferes with the expectations of creditors. An unsecured creditor is stayed, by § 362 of the Code, from exercising its rights against a borrower in bankruptcy.¹⁷⁸ A secured creditor is stayed from foreclosing on its collateral.¹⁷⁹ Sometimes, a creditor is enjoined from proceeding against a guarantor.¹⁸⁰ However, a creditor can mitigate the harsh results of a debtor's bankruptcy. For instance, creditors can take steps to assure that they receive a greater payment in bankruptcy by obtaining collateral.¹⁸¹ Therefore, it is necessary to decide whether letters of credit are so important to the public interest that creditors should be able to use them to avoid the effects of a debtor's bankruptcy.

The public interest in upholding unique commercial devices has been held paramount in bankruptcy proceedings involving surety bonds. Courts have been asked to enjoin surety bonds in bankruptcy proceedings under the automatic stay provision of the Code, § 362,¹⁸² and under § 105.¹⁸³ Like letters of credit, surety bonds do not become part of a debtor's estate.¹⁸⁴ The purpose of obtaining a surety bond is similar to the purpose of obtaining a letter of credit: the protection of intended beneficiaries if the primary obligor fails to perform for any reason, including bankruptcy.¹⁸⁵ In *Dore*,¹⁸⁶ the court weighed the interest in promoting successful reorganizations against the public interest in protecting the integrity of construction performance bonds.¹⁸⁷ The court

174. 33 B.R. 681 (Bankr. D.S.D. 1983).

175. *Id.* at 685.

176. *Id.*

177. *Id.* at 681.

178. 11 U.S.C. § 362(a)(1) (1988).

179. *Id.* § 362(a)(4) (1988).

180. *Lahman*, 33 B.R. at 681.

181. Creditors receive the full amount of their secured claims in bankruptcy. 11 U.S.C. § 506 (1988). See generally BENJAMIN WEINTRAUB & ALAN N. RESNICK, BANKRUPTCY LAW MANUAL ¶ 5.14 (rev. ed. 1986).

182. *Fintel v. Oregon (In re Fintel)*, 10 B.R. 50 (Bankr. D. Or. 1981).

183. *Dore & Assocs. Contracting, Inc. v. American Druggists' Ins. Co. (In re Dore & Assocs. Contracting, Inc.)*, 54 B.R. 353 (Bankr. W.D. Wis. 1985).

184. *Fintel*, 10 B.R. at 51.

185. *Id.* at 52.

186. 54 B.R. 353.

187. *Id.* at 353.

was not convinced that a reorganization was less likely to occur if the surety suit were allowed to proceed.¹⁸⁸ On the other hand, the harm to the public interest in the commercial integrity of performance bonds was considerable because Wausau, the beneficiary of the performance bond, was enjoined from suing on the bonds for three years.¹⁸⁹ The court claimed that such an injunction undermined the integrity of construction bonds in general.¹⁹⁰

To evaluate the public policy behind upholding letters of credit, it is necessary to revisit the independence principle. The beneficiary of a letter of credit requests the letter in order "to make certain that, if the other party to the contract defaults, the beneficiary can gain access to a secure fund of money which he can use, say, to satisfy the other party's debt to him . . . or to . . . substitute performance."¹⁹¹ A beneficiary, in obtaining a letter of credit, does so to make certain that any dispute on the underlying contract will "wend [its] way towards resolution with the money in the beneficiary's pocket rather than in the pocket of the [beneficiary's adversary]."¹⁹² The beneficiary, by bargaining for a letter of credit instead of a guaranty or other security device—enforcement of which may, in the case of a guaranty, or would, in the case of other security, be stayed by operation of the automatic stay or by application of § 105—should be able to avoid the consequences of the debtor's bankruptcy.

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."¹⁹³ Thus, courts have upheld payment when the documents have some basis in fact,¹⁹⁴ but have enjoined payment when the beneficiary has no bona fide claim to payment, as in a commercial letter of credit when the beneficiary ships worthless material intended to simulate actual merchandise.¹⁹⁵

There are additional strong policy reasons for upholding letters of credit in the face of an account party's bankruptcy. Letters of credit are often issued in connection with public bond financing. Industrial development bonds and economic development bonds are issued to finance projects in the public interest. The various state-enabling statutes specify

188. *Id.* at 360.

189. *Id.* at 362.

190. *Id.*

191. *Ground Air Transfer v. Westates Airlines*, 899 F.2d 1269, 1272 (1st Cir. 1990).

192. *Itek Corp. v. First Nat'l Bank*, 730 F.2d 19, 24 (1st Cir. 1984).

193. *Intraworld Indus. v. Girard Trust Bank*, 336 A.2d 316, 324-25 (Pa. 1975).

194. *Id.* at 325.

195. *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631, 634 (Sup. Ct. 1941).

that the financing will be available for enterprises that will, among other things, create new job opportunities¹⁹⁶ and benefit economically distressed communities.¹⁹⁷

Industrial development bonds would be unmarketable if they were not secured by the known credit of a bank through a letter of credit.¹⁹⁸ The court in *Diamond Machine Co. v. Casco Northern Bank (In re Diamond Machine Co.)*¹⁹⁹ recognized the strong public policy behind the Maine Finance Authority Act in refusing to enjoin payment on a letter of credit issued for the account of a bankrupt debtor.²⁰⁰ The stated purpose of the Finance Authority Act was to stimulate a larger flow of private investment funds and to increase the access of smaller businesses to financing at reasonable terms and rates.²⁰¹ The debtor argued that payment of the letter of credit would severely jeopardize its efforts to reorganize.²⁰² The court refused the debtor's request, noting that letters of credit have a unique and favored status in business and commerce.²⁰³ The court held that granting an injunction would create havoc in the bond markets and defeat the public policy behind the state statute.²⁰⁴

If letters of credit could be enjoined simply because of an account party's bankruptcy, they would lose their defining features of independence and prompt payment. There is a great public interest in upholding letters of credit because without them, many types of financing could not occur. Furthermore, the policies behind the Bankruptcy Code are not defeated by upholding letters of credit because creditors are permitted, in structuring loan transactions, to bargain for better positions in bankruptcy. For instance, secured creditors and unsecured creditors are not treated equally—secured creditors receive the value of their security while unsecured creditors may only receive a small percentage of their claims. Oversecured creditors are treated more favorably than other se-

196. See, e.g., ILL. ANN. STAT. ch. 20, para. 3 (Smith-Hurd 1993).

197. CAL. GOV'T CODE § 91501 (West 1987).

198. Bond ratings are based on the creditworthiness of the bank issuing the letter of credit supporting the bond. *Fitch Issues L/C-Backed Bond Rating Guidelines in Light of 'Prime Motor'*, LETTER OF CREDIT UPDATE (Gov't Info. Servs.) at 8, 8 (Feb. 1991).

199. 95 B.R. 255 (Bankr. D. Me. 1988). In *Diamond Machine*, the debtor caused a letter of credit to be issued in favor of the indenture trustee for the bonds. The existence of the letter of credit was a condition precedent to issuing these bonds, and the documents executed in connection with the bonds stated, "Bond Purchasers are unwilling to purchase the Bonds unless the Bonds are further secured by an irrevocable letter of credit issued by the Bank." *Id.* at 256.

200. *Id.*

201. ME. REV. STAT. ANN. tit. 10, § 962 (West Supp. 1992).

202. *Diamond Mach.*, 95 B.R. at 257.

203. *Id.*

204. *Id.* at 258.

cured creditors in that oversecured creditors are entitled to postpetition interest. Creditors who obtain guarantees from nondebtor guarantors may be paid notwithstanding the automatic stay. Letters of credit should be treated like any of these other loss-limiting devices. Therefore, creditors who insist on receiving letters of credit should receive immediate payment notwithstanding the debtor's bankruptcy filing.

IV. CONCLUSION

Courts faced with the question of whether to enjoin letters of credit in bankruptcy cases have received scant statutory guidance. Left to their own devices, courts have misapplied the Code and improperly applied the balancing test for injunctions. Applying the anti-*ipso facto* provisions of § 365 to letters of credit is inappropriate because the purpose of a letter of credit is to shift all risks of nonperformance from the beneficiary to the issuer. As for the test for injunction, the only prong of the test that a debtor could likely satisfy would be that of likelihood of success on the merits—a successful reorganization. It is unlikely that a debtor would suffer irreparable harm as a result of payment of a letter of credit, because all actions against the debtor will be stayed while the bankruptcy case is pending. Further, the harm to the creditor who asked for the letter of credit will be great, for the creditor will be deprived of its bargain. Finally, the public interest weighs in favor of upholding letters of credit because of their special place in the world of finance.

Perhaps the best way to guide courts faced with this issue would be to codify the special status of letters of credit in bankruptcy. Therefore, the time is right for explicitly recognizing letters of credit in the Bankruptcy Code by including them within the "financial accommodation" exception to § 365(e) and by specifically prohibiting injunctions against payment of letters of credit.