Suffolk University
Digital Collections @ Suffolk

Suffolk University Law School Faculty Works | Suffolk University Law School

1-1-1992

The Flip Side of Twist Cap: Letters of Credit as Executory Contracts in Bankruptcy

Stephen M. McJohn
Suffolk University, smcjohn@suffolk.edu

Follow this and additional works at: https://dc.suffolk.edu/suls-faculty

Part of the Bankruptcy Law Commons

Recommended Citation
38 WAYNE L. REV. 1379 (1992)

This Article is brought to you for free and open access by the Suffolk University Law School at Digital Collections @ Suffolk. It has been accepted for inclusion in Suffolk University Law School Faculty Works by an authorized administrator of Digital Collections @ Suffolk. For more information, please contact dct@suffolk.edu.

THE FLIP SIDE OF *TWIST CAP*: LETTERS OF CREDIT AS EXECUTORY CONTRACTS IN BANKRUPTCY

STEPHEN M. MCJOHN†

BACKGROUND

Courts[1] and commentators[2] now widely reject *In re Twist Cap, Inc.*,[3] the first case to explore the effect of an account party's bankruptcy on a letter of credit. *Twist Cap* held that the automatic stay, which bars acts against property of the bankruptcy estate, prevents a draw under the letter of credit. The court reasoned that payment to the beneficiary by the bank causes the bank to have a claim for reimbursement from the account party's bankruptcy estate.[4] The accepted view now is that the automatic stay does not affect the letter of credit in such a situation. Rather, courts view the letter of credit as an engagement that runs only from the bank to the beneficiary, legally independent of the bank's relationship with the account party. This article advocates a reversal of authority in a converse situation, i.e., the effect of the beneficiary's bankruptcy on a letter of credit.

---

† Visiting Assistant Professor of Law, Chicago-Kent College of Law, Illinois Institute of Technology. J.D., 1985, Northwestern University School of Law.

I wish to thank John Dolan for his thoughtful comments on earlier versions of this article and to thank the others who have discussed the topic with me.

1. *See, e.g.*, *In re* Compton Corp., 831 F.2d 586, 590 (5th Cir. 1987) (*Twist Cap* "has been roundly criticized and otherwise ignored by courts and commentators alike"); *In re* Clothes, Inc., 35 Bankr. 487, 489 (Bankr. N.D. 1983) (declining to follow "whatever rationale has evolved from the *Twist Cap* case" as contrary to long established commercial law principles); *In re* Planes, Inc., 29 Bankr. 370, 371 (Bankr. N.D. Ga. 1983) (declining to follow *Twist Cap*). The Shepherd's entry for *Twist Cap* is so full of notations for "criticized," "explained," "questioned," and "distinguished" as to inspire sympathy for the judge.

2. *See, e.g.*, Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130 (1982); Chaitman & Sovern, *Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a Twist Cap*, 38 BUS. LAW. 21 (1982); McLaughlin, *Letters of Credit as Preferential Transfers in Bankruptcy*, 50 FORDHAM L. REV. 1033 (1982).

3. *In re* Twist Cap, 1 Bankr. 284 (Bankr. D. Fla. 1979).

4. *Id.* at 285-86.

HeinOnline -- 38 Wayne L. Rev. 1379 1991-1992

According to the only case on point, *In re Swift Aire Lines*,[5] and the Bankruptcy Code's legislative history, the bankruptcy of the beneficiary of a letter of credit terminates the letter of credit. A bankruptcy trustee or debtor in possession may not assume an executory contract (1) if it is a contract to provide "financial accommodations" (i.e., an agreement to extend credit) to the debtor or (2) if applicable law excuses the nonbankrupt party from accepting performance from or rendering performance to any entity other than the debtor (i.e., the contract is nontransferable).[6] Relying on what seems the clear guidance of the legislative history, the *Swift Aire* court held that a letter of credit is an executory contract to provide financial accommodations to the beneficiary: "[U]nder [this] provision, contracts such as loan commitments and letters of credit are nonassignable, and may not be assumed by the trustee."[7] Under a loan commitment, a bank promises to advance funds to the debtor and depends on the debtor's credit risk. Under a letter of credit, a bank agrees to pay the beneficiary. A bank, however, depends not on the recipient of the funds for repayment, but rather only on the account party's credit risk. A letter of credit, therefore, is neither a means to extend credit to the beneficiary nor a commitment to extend credit to the beneficiary in the future. Rather, it is a device by which the issuer extends credit to the *account party* (and generally by which the account party *avoids* extending credit to the beneficiary). Indeed, in *Swift Aire*, the apparent reason that the bank sought to prevent assumption of the letter of credit was the account party's inability to reimburse the bank. The *Swift Aire* decision permitted the bank to achieve what it could not have done in the bankruptcy of the account party without reviving the *Twist Cap* doctrine. Rather than terminating letters of credit when beneficiaries (as in *Swift Aire*) or account parties (as in *Twist Cap*) go bankrupt, section 365 of the Bankruptcy Code,[8] properly applied, would terminate contracts that oblige banks to *issue* letters of credit for the account of bankrupt entities. In addition, letters of credit may be used as devices to fund *separate* executory contracts to provide financial

---

5. *See In re* Swift Aire Lines, Inc., 30 Bankr. 490, 496 (Bankr. 9th Cir. 1983).

6. *See* 11 U.S.C. § 365(c) (1988 & Supp. II 1991).

7. *Swift Aire*, 30 Bankr. at 496 (quoting H.R. REP. No. 595, 95th Cong., 1st Sess., *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6304).

8. 11 U.S.C. § 365 (1988 & Supp. II 1991).

HeinOnline -- 38 Wayne L. Rev. 1380 1991-1992

accommodations. In such a case, the analysis would properly focus on the contract to provide financial accommodations, not on the funding device.

The *Swift Aire* court also held that the trustee did not succeed to the rights of the debtor under the letter of credit by operation of law. This article rejects the arguments that letters of credit are rendered nontransferable (and thus fall within the second category of nonassumable executory contracts) by either the rule governing consensual transferability of letters of credit or by the rule of "strict compliance."[9] The rule restricting transferability of letters of credit applies only to consensual transfers: both precedent and the policies behind the rule support transfer to a trustee by operation of law.[10] As to "strict compliance," *Swift Aire* held that, where the letter of credit required presentation of a certificate signed by an officer of the beneficiary corporation, a certificate signed by the trustee did not strictly comply with the terms of the letter of credit.[11] This holding does not prevent assumption of letters of credit by the trustee.[12] Rather, the holding only requires the trustee to obtain the necessary certificate from the debtor. *Swift Aire*, however, further held that the trustee was unable to present a certificate signed by an officer of the beneficiary. The court reasoned that the filing of the bankruptcy petition suspended the beneficiary's corporate existence.[13] This holding, however, is not only based on an outdated concept of the relationship between the estate and the debtor that is contrary to the explicit statutory scheme of the Bankruptcy Code,[14] but it also extends that concept far beyond its appropriate scope.

Letters of credit[15] and bankruptcy litigation[16] are increasing in variety and volume. Thus, the question of whether a trustee (or a

---

9. The rule of "strict compliance" states that documents tendered to draw under a letter of credit must comply perfectly with the conditions set forth in the letter of credit. *See infra* notes 118-22.

10. *See infra* notes 101-12.

11. *Swift Aire*, 30 Bankr. at 496.

12. *See infra* text accompanying note 123.

13. *Swift Aire*, 30 Bankr. at 495-96.

14. *See* 11 U.S.C. § 365(c).

15. *See infra* note 84. Assessments of the future of the letter of credit vary considerably. *Compare* Symons, *Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338, 339 (1980) ("The only limits are the creative abilities of those who use them."); Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 582 (1979) ("The use of this financial tool seems limited only by the creativity of man.") *and* Note, *Letters*

HeinOnline -- 38 Wayne L. Rev. 1381 1991-1992

debtor in possession acting with the powers of a trustee) succeeds to the rights of a bankrupt beneficiary under a letter of credit is likely to arise more frequently. Resolving the issue will obviously affect the amount of assets that bankruptcy estates have to distribute or use in reorganization. The *Swift Aire* rule incorrectly relieves parties with obligations to bankruptcy estates, to the detriment of the creditors and other parties with interests in such estates. The possibility of bankruptcy terminating letters of credit will also make creditors less likely to lend to debtors whose assets include letters of credit.

Collateral that disappears if the debtor goes bankrupt is hardly worth calling "security." For example, the *Swift Aire* holding throws a shadow over the back-to-back letter of credit, a financing device specifically encouraged by the Uniform Commercial Code. In a back-to back letter of credit, the letter of credit's beneficiary assigns the letter's proceeds to a bank as security in order to obtain issuance of another letter of credit.[17] If the first letter of credit could be nullified by the beneficiary's bankruptcy, a bank should be reluctant to take the letter of credit as security for a back-to-back letter of credit or for any extension of credit. Another indirect effect is in the area of guaranties. If letters of credit can be nullified by bankruptcy, it would be difficult to draw a principled distinction to prevent the same result with guaranties. Guaranties, though unlike letters of credit in some important ways, share legal attributes relevant to the issue at hand.[18]

---

of Credit: Doubts as to Their Continued Usefulness, 8 N.Y.L. SCH. J. INT. & COMP. L. 327 (1987).

16. *See, e.g.*, Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Sontag, *Amid Bust, a Boom*, NAT'L. L. J., Apr. 2, 1990, at 1.

17. There are other reasons why a bank should have concerns about issuing a back-to-back letter of credit. For example, unless the bank also has the right to draw under the first letter of credit, it cannot realize on such collateral without action on the part of the beneficiary.

18. *See* Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 724-28 (1973) (discussing the dangers to banks of issuing standby letters of credit, the risks of which were more like guaranties than like traditional letters of credit); Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 TUL. L. REV. 314, 314 n.1 (1979) (discussing the issue five years later and querying whether the term "standby letter of credit" had gained greater currency than "guaranty letter of credit" so as to avoid the issues of whether such letters were in fact illegal guaranties). *See also* Gable, *Standby Letters of Credit: Nomenclature has Confounded Analysis*, 12 LAW & POL'Y INT'L BUS. 903, 914 (1980) (arguing that because standby letters of credit are like guaranties, they should be treated under the law of contracts respecting

HeinOnline -- 38 Wayne L. Rev. 1382 1991-1992

Although *Swift Aire* remains the only case on point, two recent cases have agreed, in dicta, with *Swift Aire*'s holding.[19] This article argues for a reversal of that trend and provides an analytical framework to resolve the issue in a manner that serves the underlying purposes of both the letter of credit and the Bankruptcy Code.

I. WHETHER A LETTER OF CREDIT IS A "CONTRACT," AND IF SO, WHETHER IT IS "EXECUTORY"

In considering what sort of executory contract a letter of credit is, the *Swift Aire* court failed to ask the threshold questions: (1) whether a letter of credit is a contract,[20] and if so, (2) whether it is "executory" under the bankruptcy law's idiosyncratic understanding of the term. While these questions would be moot under my position, which would permit a letter of credit to become part of the beneficiary's estate, whether as an executory contract or simply as property of the estate, the answers to the above questions are critical to the *Swift Aire* holding. To defend the holding of *Swift Aire*, one needs to show that a letter of credit is an executory contract. If the letter of credit is not an executory contract, the letter would become property of the estate, as the prohibitions against assuming nontransferable contracts and contracts to provide financial accommodations do not apply to other property of the estate. Indeed, Section 541 of the Bankruptcy Code[21] explicitly nullifies contractual provisions or applicable law that restrict or

guaranties, not under the law governing letters of credit); Kutskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697 (1975) (discussing whether national banks are barred from issuing standby letters of credit because they are similar to guaranties). For a recent discussion, see Kozolchyk, *Bank Guaranties and Letters of Credit: Time for a Return to the Fold*, 11 U. PA. J. INT'L. BUS. L. 7 (1989).

19. *See* Tarantino v. Strutz Kentucky Park, Ltd., Nos. 4-86-695, 4-86-266 (D. Minn. 1989); *In re* Taggatz, 106 Bankr. 983 (Bankr. W.D. Wis. 1989).

20. The Bankruptcy Code rules governing executory contracts do not apply to noncontractual arrangements. For example, the rules do not apply to the debtor's rights and obligations arising out of a covenant running with the land. *See In re* Case, 91 Bankr. 102 (Bankr. D. Colo. 1988). *See In re* Mahan & Rowsey, Inc. 817 F.2d 682, 684 n.3 (10th Cir. 1987) ("A constructive trust is neither executory nor a contract"). *See* Sherwin, *Constructive Trusts in Bankruptcy*, 1989 U. ILL. L. REV. 297 (discussing how constructive trusts are treated in bankruptcy).

21. 11 U.S.C. § 541 (1988 & Supp. II 1991).

HeinOnline -- 38 Wayne L. Rev. 1383 1991-1992

condition transfers of property of the estate.[22] This section, therefore, will outline the analysis of the issues.

The letter of credit, in one form or another, has been in commercial usage for centuries in various parts of the world.[23] Its usage is increasing in amount and variety.[24] Article 5 of the Uniform Commercial Code is devoted to the law governing letters of credit.[25] The International Chamber of Commerce has developed the Uniform Customs and Practices for Documentary Credits (Uniform Customs),[26] which is an internationally-accepted set of

---

22. Section 541 also nullifies contractual provisions or applicable law that are conditioned on the insolvency or bankruptcy of the debtor and would effect a forfeiture or termination of the debtor's interest in property. Anything in a contract or applicable law that would let a bank "off the hook" simply because of the debtor's bankruptcy would, therefore, be nullified. *Accord* Federal Deposit Ins. Corp. v. Bank of Boulder, 911 F.2d 1466 (10th Cir. 1990), *cert. denied*, 111 S. Ct. 1103 (1991). The *Bank of Boulder* court held that the FDIC succeeded to the right to draw under a letter of credit issued to the bank that subsequently became insolvent. The court stated that "if Colorado's transfer restrictions were enforced against FDIC in this case, Bank of Boulder would likely receive an unexpected benefit." *Id.* at 1477.

23. "Letters of credit in their oldest form were in common use by the princes and rulers of the twelfth century to procure advances for their servants." Thayer, *Irrevocable Credits in International Commerce: Their Legal Nature*, 36 COLUM. L. REV. 1032, 1032 (1936). "It has been suggested that the origins of the letters of credit can be traced to ancient Syrian rug merchants, Phoenician traders and the Mitsui Bank of old Japan." Comment, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 226 & n.50 (1985).

24. See *infra* note 84.

25. U.C.C. §§ 5-101 to 5-117 (1989).

26. International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits, Pub. No. 400 (1983) [hereinafter Uniform Customs]. For discussions of the nature of the Uniform Customs, see Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C. L.J. 7, 8 (1971); Comment, *Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions*, CUMB.-SANFORD L. REV. 134, 154-60 (1973).

Article 5 of the Uniform Commercial Code governs letters of credit. However, letters of credit in the United States generally contain a provision similar to the following:

> This Letter of Credit is issued subject to the Uniform Customs and Practice for Documentary Credits (1983 Revision), International Chamber of Commerce Publication No. 400, or any later revision which may be in effect at the time, and where not in conflict, shall be governed by Article V of the Uniform Commercial Code as in effect in the State of ____ and engages us in accordance therewith.

Such a provision is enforceable under the Uniform Commercial Code, which provides that the "effect of provisions of this Act may be varied by agreement." U.C.C. § 1-102(3) (1989). Article 5 of the Uniform Commercial Code and the

HeinOnline -- 38 Wayne L. Rev. 1384 1991-1992

rules to govern letters of credit. While letters of credit have been at issue in much litigation,[27] there is no definitive answer to the fundamental question, whether a letter of credit is a contract.

Although this issue was once important and widely disputed, it has been made moot for most purposes and has been of waning academic interest. Before the states enacted Article 5 of the Uniform Commercial Code and before the Uniform Customs gained general acceptance, there was considerable discussion of the issue. In order to decide what rights and obligations, if any, arose from a letter of credit, it was thought necessary to determine its position in the existing legal framework.[28] Because a letter of credit is essentially a promise to make payment on the fulfillment of certain conditions, it appears at first blush to be a contract. The authorities divided, however, on whether there was consideration given to the bank, which would be necessary for a binding contract to exist. Few cases arose on the issue, as such an argument is contrary to the issuing bank's interest. If any bank had contended that the letters of credit it issued were not binding legal obligations because of a failure of consideration, then that bank's business in issuing letters of credit would have quickly shrunk.[29] The issue, then, was largely left to the commentators. The two views are best represented in two articles on the "legal nature" of letters of credit by leading commentators, Philip Thayer and Boris Kozolchyk.[30]

Thayer concluded that a letter of credit was a contract, after craftily negotiating the requirement of consideration.[31] A letter of

---

Uniform Customs are largely in agreement. This article will cite to both the Uniform Commercial Code and the Uniform Customs, where applicable. Although different in some minor respects, the two are largely consistent.

See Note, *The Conflicts of Law in International Letters of Credit*, 24 VA. J. INT'L L. 171 (1983) (considerations involved in providing for the governing law).

27. Reference, however, to almost any state's annotated Uniform Commercial Code will show that there have been far fewer cases under Article 5 than under Article 2 (Sales) and Article 9 (Secured Transactions).

28. *See* Dolan, *Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Goldsmiths in Lombard Street?)*, 7 CARDOZO L. REV. 1, 34 (1985) (describing the attempts of English courts in the eighteenth century to categorize the letter of credit).

29. *See* B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS 459-60 (1966).

30. *See* Thayer, *supra* note 23; Kozolchyk, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 AM. J. COMP. L. 395 (1965).

31. Thayer, *supra* note 23, at 1054-60.

HeinOnline -- 38 Wayne L. Rev. 1385 1991-1992

credit is an irrevocable promise, which the bank issues, to pay the beneficiary upon the fulfillment of specified conditions. The bank requires no quid pro quo from the beneficiary. The promise could be fit into the framework of contract law by treating the letter of credit as an offer that becomes a binding contract when complying documents are proffered. But if the letter of credit is merely an offer, then it would be revocable. Irrevocability, however, is key to the letter of credit. Thus, Thayer sought a source of consideration for the issuance of the letter of credit.

One could argue consideration comes from the action of the account party. Thayer rejected this approach for two reasons.[32] First, under English law, such a contract was not enforceable. England had been instrumental in developing the letter of credit as an instrument of international trade, and a satisfactory theory should make the letter of credit enforceable in its place of origin.[33] Second, the enforceability of the letter of credit should not depend on whether the account party actually furnishes consideration; a letter of credit should be enforceable, even if the account party does nothing.[34] Moreover, fraud by the account party in procuring the letter of credit or the account party's subsequent insolvency[35] should not affect the letter of credit, as would be true if it were enforceable only upon valid consideration from the account party.

Instead Thayer managed to find consideration flowing from the beneficiary:

> The undertaking of the bank to honor drafts is made in consideration of a prior undertaking by the seller to surrender documents to the bank instead of to the buyer. This undertaking is not express, but is necessarily to be implied from the stipulation by the seller in the contract of sale for an irrevocable credit.[36]

While this clever resolution for finding consideration is plausible in sales transactions, it would not always suffice in the more varied

---

32. *Id.* at 1039-40.

33. *Id.* at 1040.

34. A letter of credit would be binding upon the bank even where the bank was not entitled to reimbursement from the account party. *See* City Nat'l Bank of Detroit v. Westland Towers Apartments, 152 Mich. App. 136, 393 N.W.2d 554 (1986), *leave to appeal denied*, 428 Mich. 885 (1987) (issuing bank was not entitled to reimbursement where it issued letter of credit without authorization).

35. Here, Thayer anticipated the *Twist Cap* issue.

36. Thayer, *supra* note 23, at 1056 (footnotes omitted).

HeinOnline -- 38 Wayne L. Rev. 1386 1991-1992

uses of the letter of credit. For example, in the typical standby letter of credit, the beneficiary does not undertake to present documents to the bank. Rather, the letter of credit is a secondary and contingent source of payment. Although the letter of credit is likely issued pursuant to a contractual provision, the beneficiary's promised action is not directed to, or for, the benefit of the bank.

Kozolchyk considered other means of finding consideration:

> The beneficiary's acts in reliance on the credit, such as ordering or manufacturing the merchandise, may be deemed to perfect his acceptance or it may be validly asserted that the bank is bound as of the moment (a) the beneficiary voiced his acceptance, (b) mailed it to his offeror, (c) the acceptance was received by the offeror, or (d) he became aware of its receipt.[37]

The objection to relying on such acts for consideration, however, is that it makes the time that the letter of credit becomes irrevocable both unpredictable and dependent on an irrelevant happenstance.[38] Kozolchyk resolved this doctrinal predicament by concluding that the letter of credit was not a contract, but was rather a species of negotiable instrument.[39]

Thayer and Kozolchyk both agreed that the law governing letters of credit was conflicting and uncertain, and that its commercial usage required uniformity.[40] This problem was largely resolved by the widespread acceptance[41] of the Uniform Customs and by the states' enactment of Article 5 of the Uniform Commercial Code, which govern the fundamental questions regarding the legal rights and obligations under letter of credit transactions. Neither addresses the issue of whether a letter of credit is a contract; rather, they render the issue moot. Thus, whether a letter

---

37. Kozolchyk, *supra* note 30, at 404-05.

38. *Id.* at 405.

39. *Id.* at 417. To further complicate matters, Thayer and Kozolchyk both concluded that the letter of credit was a mercantile specialty. *See* Thayer, *supra* note 23, at 1056-57; Kozolchyk, *supra* note 30, at 417.

40. *See* Thayer, *supra* note 23, at 1059-60; Kozolchyk, *supra* note 30, at 420.

41. Although the first edition of the Uniform Customs was adopted in 1933, "global acceptance" was given first to the 1962 revision. Uniform Customs, *supra* note 26, at 5-6. *See* Comment, *supra* note 26, at 156. U.C.C. Article 5 and the Uniform Customs were, therefore, both in existence at the time of Kozolchyk's article but impacted little in its analysis.

HeinOnline -- 38 Wayne L. Rev. 1387 1991-1992

of credit is considered a contract is now of little importance in letter of credit law. The validity, transferability, and enforceability (including the rule that consideration is not required to make a letter of credit enforceable) of letters of credit; bank obligations under a letter of credit; and the warranties made by a beneficiary upon drawing under a letter of credit are all governed by the Uniform Customs and Article 5. The need to place the letter of credit in a legal category no longer exists.

Yet commentators have continued to address the issue, albeit less frequently and urgently. The majority of commentators, heeding the statement of the official comments to the U.C.C. that Article 5 is intended to provide "an independent theoretical frame," have concluded that a letter of credit is not a contract.[42] Rather than force the letter of credit to fit within the existing legal taxonomy, commentators regard it as *sui generis*, a sort of legal platypus. For example, White and Summers state:

> Letters of credit are neither contracts nor negotiable instruments. A letter of credit is not a guaranty contract because the obligation of an issuer is primary and the obligation of an issuer arises upon presentment of documents in compliance with the letter of credit. The obligation of a guarantor is secondary and arises upon the principal debtor's default. A letter of credit is not a third party beneficiary contract because the claim of a beneficiary is not subject to the defenses the issuer might have against

---

42. *See* Note, *Letters of Credit: the Role of Issuer Discretion in Determining Documentary Compliance*, 53 FORDHAM L. REV. 1519, 1519 n.2 (1985) (citing a number of commentators who have concluded that a letter of credit is not a contract). The note concludes, however, that a letter of credit is a contract, or rather an "irrevocable offer looking to a unilateral contract." The note contends that agreement to a contract can be implied from the conduct of the beneficiary (although it apparently equivocates on this point, also viewing the letter of credit as only an offer until accepted). *Id.* at 1531 n.87, 1533 n.97. The note further argues that consideration may be found in the acts of the account party. As discussed above, there were drawbacks to this approach even before the U.C.C. was enacted. Now, where governing law provides that consideration is not necessary, stretching to find consideration is wholly artificial and, under the independence principle, irrelevant.

The reason that the note seeks to characterize a letter of credit as a contract is to make the rulings of equity and substantial performance under contract law available as a means to relax the requirement of strict compliance. But the standards of compliance will be decided with reference to the unique nature of a letter of credit, whether it is called a "contract" or not.

HeinOnline -- 38 Wayne L. Rev. 1388 1991-1992

> the customer on the contract for the letter of credit. A letter of credit is not a negotiable instrument because it is not payable to order or bearer, and it is typically conditional. A letter of credit is a letter of credit.[43]

Whether a letter of credit is formally a "contract" under nonbankruptcy law, however, does not determine whether it is a "contract" for the purposes of the Bankruptcy Code.[44] For example, a valid formalist view would be that even if the letter of credit is considered to fit within the framework of contract law, the letter of credit is only an offer rather than a contract until the beneficiary accepts by making a draw.[45] However, this would be a questionable basis on which to contend that section 365 does not apply. Consistent application of this argument would require the conclusion that the trustee, although unable to assume a

---

43. J. WHITE & R. SUMMERS, HANDBOOK OF LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-2 at 711 (2d ed. 1980) [hereinafter J. WHITE & R. SUMMERS (2d ed. 1980)].

White and Summers equivocate slightly on the question in the third edition: "One of your editors hesitates to call that obligation contractual, but to call it a contract does not offend the other." J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE, § 19-2 at 813 (3d ed. 1988). They conclude the chapter by reaffirming the position that a letter of credit is not a contract. For a careful discussion concluding that a letter of credit is not a contract, see Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 588-92 (1979).

44. Courts have looked through formal arrangements to decide the applicability of § 365. For example, a debtor may be a party to a lease where title to the leased property passes to the debtor at the end of the lease term, if the debtor has made all the required payments. Assume the debtor goes into bankruptcy during the lease term and the lessor has not perfected a security interest in the leased property. If § 365 governs, the lessee receives the property only if it assumes the lease, which would require it to cure defaults and assure payment in full. But courts and commentators agree that if the unexpired lease is in fact a security agreement rather than a "true lease," § 365 does not apply. *See, e.g., In re* Pacific Express, 780 F.2d 1482, 1487 (9th Cir. 1986) (collecting cases and commentaries). The lessor would then have an unperfected security interest in the property, which the trustee may avoid under § 544, resulting in an unsecured claim for the unpaid portion of the purchase price.

The courts have been split on a similar question—whether a land sales contract is subject to § 365. *Compare In re* Terrell, 892 F.2d 469 (6th Cir. 1989) (holding that nonbankrupt party purchasers' interest in a land contract was an executory contract, not a secured claim) *and In re* Speck, 798 F.2d 279 (8th Cir. 1986) (holding that a contract for deed is an executory contract because right of vendor to receive payment and right of vendee to take title are dependent covenants).

45. *See, e.g.* Kozolchyk, *supra* note 30, at 403-04.

HeinOnline -- 38 Wayne L. Rev. 1389 1991-1992

contract embodying a commitment to make a loan to the debtor, would nevertheless have the right to accept and make binding a pre-petition offer[46] to make a loan.

The differences, however, between contract law and the rules of both the Uniform Customs and Article 5 of the Uniform Commercial Code are more than formalities. Those sets of rules were drafted specifically to prevent the most basic rules of contract law from applying to letters of credit. In Professor Dolan's words,

> Most courts refer to the credit undertaking as a contract. That terminology is unfortunate, since the credit is certainly a peculiar kind of contract, and it is a cold court indeed that attempts to weather the storm of credit analysis with nothing more than general contract principles for warmth. Credits need no consideration, must be in writing, are peculiarly independent of contracts directly related to them, are transferable in only limited circumstances, have unique provisions for damages in the event of breach, and generally do not lend themselves to contract rules regarding performance. In short, the law does not treat them in the way it treats most contracts. It is more accurate to say that credits are sui generis and that the law of contracts supplements the law of credits only to the extent that contract principles do not interfere with the unique nature of credits.[47]

Professor Dolan takes the pragmatic view that it does not matter what a letter of credit is called, provided that the proper rules are applied.[48]

---

46. There are formalist responses to this. Because offers are revocable, the nonbankrupt party would be free to retract an offer to make a contractual loan commitment. Therefore, if the nonbankrupt party permitted the offer to remain outstanding after the petition in bankruptcy was filed, it would have no grounds to complain of its acceptance.

Another argument is that § 365 has consistently been interpreted to be inapplicable after the point in time that contracts are no longer executory. If one party has completely performed before the petition is filed, the contract is no longer executory and § 365 does not apply. Similarly, § 365 does not apply if the contract has been terminated pre-petition. Accordingly, a similarly bright line at the beginning of the contract would make § 365 inapplicable where the contract has not yet been formed.

47. J. Dolan, The Law of Letters of Credit ¶ 2.02 (1984).

48. There are many statements in the cases and commentary to the effect that a letter of credit is a contract. However, these statements were not addressed,

HeinOnline -- 38 Wayne L. Rev. 1390 1991-1992

The question of whether a letter of credit is to be considered an executory contract for purposes of the Bankruptcy Code should be addressed in a similarly pragmatic way. One should determine whether section 365 was intended to apply to the legal structure of rights and obligations surrounding a letter of credit. Such an approach to the interpretation of nonbankruptcy terms in the bankruptcy context was taken by the court in *Chicago Board of Trade v. Johnson.*[49] In *Johnson*, the United States Supreme Court held that the Illinois Supreme Court's holding that a seat on the Chicago Board of Trade was not "property" was not determinative of whether the seat was "property" under federal bankruptcy law.

---

or even acknowledged. For example, a treatise on letters of credit states:

> Unlike a negotiable instrument, a letter of credit does not convey a unilateral obligation; it is an executory contract that conditions performance of the issuer's obligation (payment) upon performance by the beneficiary (delivery of specified documents).

H. Harfield, Letters of Credit 79 (1979). In another writing, the commentator defines contract overbroadly as "any agreement or arrangement that describes prospective action by the parties." Harfield, *Identity Crises in Letter of Credit Law*, 24 Ariz. L. Rev. 239, 248 (1982). This definition is appropriate in the context of the article's discussion, but would take the word "contract" far beyond its present meaning if used as a general definition.

The Fifth Circuit stated in a different context that a letter of credit is an executory contract, but did so in a self-defeating fashion: "Our reading of the relevant case law and commentaries confirms that at its essence a credit is a peculiar form of executory contract, one whereby the issuer makes a continuing offer to pay upon the beneficiary's performance of the terms and conditions stipulated in the credit." Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 238 (5th Cir. 1983) (citing J. White & R. Summers, Uniform Commercial Code, § 18.2 at 711-12 (2d ed. 1972)). Within a single sentence the court referred to a letter of credit as a contract and as an offer, a precursor to a contract. In addition, the *White & Summers* citation does not provide authority for the proposition that a letter of credit is any kind of contract. To the contrary, White and Summers state that a letter of credit is *not* a contract. J. White & R. Summers (2d ed. 1980), *supra* note 43, § 18.2 at 711.

The *Philadelphia Gear* court held that the beneficiary, by "knowingly tendering nonconforming drafts," breached provisions of the Louisiana Code requiring good faith in the performance of contracts and honesty in fact in the conduct of transactions. 717 F.2d at 238. Whether the letter of credit was an executory contract or an offer before tender of the drafts was not at issue. For a statement that letters of credit are not "executory contracts," also not addressing the term with respect to the meaning under the Code, *see* Seattle-First Nat'l Bank v. Federal Deposit Ins. Corp,. 619 F. Supp. 1351, 1363 (D. Okla. 1985) (letters of credit were not "merely executory contracts and contingent liabilities," and accordingly insolvent bank's receiver was liable on the letters of credit).

49. 264 U.S. 1 (1924).

HeinOnline -- 38 Wayne L. Rev. 1391 1991-1992

Following the *Johnson* approach, our question then becomes not what is meant in a nonbankruptcy context by an "executory contract" but rather what the Bankruptcy Code means by an "executory contract." As noted in *Johnson*, a term may take on a different meaning in the bankruptcy context.

The term "executory contract" is not defined in the Bankruptcy Code. The most common usage under nonbankruptcy law divides contracts into executed and executory contracts: if nothing remains to be done by *either* party, the contract is executed, otherwise it is executory.[50] This is not the meaning under the Bankruptcy Code.

The Bankruptcy Code has an idiosyncratic and elusive understanding of the term "executory contract." Although courts and commentators have differed both on whether specific contracts are executory for the purposes of the Bankruptcy Code and on the appropriate test to decide the issue, there is agreement that a contract is executory only if there remain things to be done by *both* parties.[51] Therefore, the set of legal entities considered executory contracts by the Bankruptcy Code is only a subset of the set delineated by the nonbankruptcy definition.

Under the widely followed test first proposed by Professor Countryman, a contract is executory for the purposes of the Bankruptcy Code if "the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance could constitute a material breach excusing the performance of the other."[52] Under a slightly different formulation, as quoted by the Supreme Court, "the legislative history of Section 365(a) indicates that Congress

---

50. *See, e.g.*, 1 S. WILLISTON, CONTRACTS § 14 (3d Ed. 1937); BLACK'S LAW DICTIONARY 292 (5th ed. 1979); Watkins v. Nugen, 118 Ga. 372, 374, 45 S.E. 262, 263 (1903) (an executory contract is one in which something remains to be done by one or more parties); Fox v. Kitten, 19 Ill. 519, 532 (1858) (where any act remains to be done, a contract is executory).

51. *But see In re* Oxford Royal Mushroom Prods., Inc., 45 Bankr. 792 (Bankr. E.D. Pa. 1985) (contract can be executory where only one party had remaining performance obligations).

52. Countryman, *Executory Contracts in Bankruptcy: I*, 57 MINN. L. REV. 439, 460 (1973). *See In re* Streets & Beard Farm Partnership, 882 F.2d 233 (7th Cir. 1989) (illustrating the uncertainty of the results of this test). Citing the Countryman test, the *Streets & Beard* court held that an installment contract for the sale of real estate was not executory. The vendor's obligation to deliver legal title upon completion of the payments did "not represent the kind of significant legal obligation that would render the contract executory." *Id.* at 235. The obligation to deliver title may be a "mere formality," but failure to do so would be a material breach.

HeinOnline -- 38 Wayne L. Rev. 1392 1991-1992

intended the term to mean a contract 'on which performance remains due to some extent on both sides.'"[53] Both formulations envision bilateral contracts with obligations (i.e., performance due) on each side. Both assume that a contract at its inception has obligations on both sides and seek to find the point when the obligation on one side or the other has shrunk sufficiently to render the contract non-executory. Until a contract reaches that point, the trustee is given a choice between assumption and rejection. Such a view fits the primary purpose of section 365, which is to give the trustee the opportunity to decide whether it is in the best interests of the estate to assume or reject the contract at issue.[54] In considering whether to reject or assume an executory contract, the trustee would generally decide whether the assets associated with the contract (the performance due from the other party) outweigh the liabilities associated with the contract (the performance due from the debtor).

The letter of credit at best fits awkwardly into this framework. The beneficiary of a letter of credit has no obligations at the outset; it owes no performance to the bank. From the point of view of the beneficiary, an outstanding letter of credit is all asset and no liability—although drawing on the letter of credit can result in absolute or contingent liabilities. Thus, with an outstanding letter of credit, the trustee would almost always want to assume the letter of credit, as it would benefit the estate, or at least not burden it. In most cases an automatic succession to the rights of the beneficiary would further the trustee's purpose, as the beneficiary has nothing to lose (because it is not required to draw) and everything to gain from an outstanding letter of credit. Indeed, the idea of the beneficiary "rejecting" an outstanding letter of credit leads to absurd consequences. Under section 365(g), rejection of an executory contract constitutes a breach of the contract. The other party then has a basis for damages against the estate as an

---

53. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n. 6 (1984), *quoting* H.R. Rep. No. 95-595, at 347 (1977). *See* Board of Trade of Chicago v. Securities & Exchange Comm'n, 883 F.2d 525 (7th Cir. 1989) (stating that option contracts are "executory contracts on one side").

54. *See, e.g.*, Bordewieck & Countryman, *The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors*, 57 AM. BANKR. L. REV. 293, 303 (1983). This policy was also primary chronologically; according to some early decisions, the power to reject executory contracts stems from the trustee's power to renounce title to and abandon burdensome property. *See* Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U. COLO. L. REV. 845, 856 (1988).

HeinOnline -- 38 Wayne L. Rev. 1393 1991-1992

unsecured creditor.[55] But a bank could not be damaged by such a "breach" since the beneficiary is not required to seek payment under a letter of credit, or indeed to do anything.[56] An outstanding letter of credit imposes no obligation on a trustee. The trustee could not benefit from being given the choice whether to continue to have the option to take advantage of the letter of credit.[57] Giving the trustee such a choice could only burden him without gain. Thus, the primary purpose of section 365 does not support treating a letter of credit as an executory contract.[58]

Permitting a trustee to decide which executory contracts become part of the bankruptcy estate, however, is not the only purpose behind section 365.[59] The provision also embodies a contrary

55. If an executory contract is first assumed and then rejected, the nonbankrupt party's claim will be a post-petition claim for administrative expenses, which has a higher priority. *See* 11 U.S.C. § 365(g)(2) (1988 & Supp. II 1991).

56. An apt analogy, or description, would be to treat an offer as an executory contract. An offeree cannot *breach* an outstanding offer, nor could the offeror suffer compensable damages from rejection of an offer. As with the letter of credit, however, this does not end the inquiry, because there are other policies at work in § 365. See *infra* notes 59-66 and accompanying text.

57. There could theoretically be a situation where the trustee may gain by rejecting a letter of credit, but such a situation would not arise out of the attributes with which § 365 is concerned, the balance of the costs and benefits under the instrument. The trustee could conceivably gain by releasing the letter of credit in order to receive a quid pro quo directly from the bank or the account party, or indirectly as a result of the consequences of the release. A more appropriate Bankruptcy Code provision for that sort of action, however, would be § 363, which authorizes the trustee to use and sell property of the estate, or § 554(a), which authorizes the trustees to abandon property that is burdensome or of inconsequential value or benefit to the estate. *See* 11 U.S.C. §§ 363, 554 (1988).

58. Another way to describe this purpose is to view an executory contract as a "mixture of an unperformed asset and a liability in the same contract." T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 106 (1986). The trustee is given the opportunity to decide whether the worth of the assets outweighs the liability. For the beneficiary, an undrawn letter of credit is all asset and no liability, just as for the bank it represents only a liability. In the terms of the Bankruptcy Code, an executory contract gives rise both to property of the estate under § 541 and to a claim on the part of the nonbankrupt party under § 502. *See* Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 247-48 (1989). For the beneficiary, the letter of credit is all property and no claim.

59. A number of "policies" for § 365 can be stated: "Those purposes include (1) taking advantage of contracts which will benefit the estate; (2) relieving the estate of burdensome contracts; (3) promoting the debtor's fresh start; (4) permitting the allowance and determination of claims; and (5) preventing parties from remaining 'in doubt concerning their status vis-a-vis the estate.'" *In re*

HeinOnline -- 38 Wayne L. Rev. 1394 1991-1992

provision which prevents the trustee from assuming certain executory contracts, regardless of whether they would benefit the estate.[60] The trustee may not assume contracts to "make a loan, or extend other debt financing or financial accommodations, to or for the benefit of a debtor,"[61] or contracts where "applicable law" excuses the nonbankrupt party from rendering performance to a person other than the debtor or the debtor in possession.[62]

This prohibition, although termed as an exception within the general rule of section 365, is more than simply an exception to the rule that a trustee may decide whether to assume executory contracts. Absent section 365, such executory contracts, as property of the debtor, would automatically become property of the estate under section 541. Thus, section 365(c) embodies not just an exception to the general policy of section 365 to give the trustee the choice whether executory contracts become part of the estate, but also the contrary policy to affirmatively exclude certain executory contracts from the estate.

As discussed above, a trustee, given the choice, would not have any reason to reject an outstanding letter of credit. Thus, the policy of permitting a trustee to choose whether to assume or

---

Monument Record Corp., 61 Bankr. 866, 868 (Bankr. M.D. Tenn. 1986), (citing *In re* Jolly, 574 F.2d 349, 351 (6th Cir. 1978), *cert. denied*, 439 U.S. 929 (1978)); *In re* Norquist, 43 Bankr. 224, 225 (Bankr. E.D. Wash. 1984); H.R. REP. 585, 95th Cong., 1st Sess. 348 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 6304. Note that these policies are neither mutually consistent, nor limited to executory contracts. The first three are implied by the primary policy of permitting the trustee to decide whether to accept or reject executory contracts. The fourth is irrelevant for present purposes because the honoring of a letter of credit would give the bank a claim against the account party, not the beneficiary. The fifth would be resolved when the question of whether a trustee succeeds to the bankrupt beneficiary's rights under the letter of credit is decided.

60. The policy of § 365 has been overstated as being simply to benefit the estate. If that were the policy, a better rule would be that all rights under executory contracts are automatically assumed and all liabilities rejected. But § 365 should not be construed to alter the existing rights of the estate and the nonbankrupt party. *See* T. JACKSON, *supra* note 58, at 119-21.

61. 11 U.S.C. § 365(c)(2).

62. These two provisions are echoed in § 365(e)(2). § 365(e)(1) provides that an executory contract may not be terminated or modified because of an ipso facto clause, i.e., a clause that is conditioned on such things as one party becoming insolvent or going into bankruptcy. § 365(e)(2) provides that this rule does not apply to the two types of executory contracts that §§ 365(c)(1) and 365(c)(2) prohibit the trustee from assuming. Thus, the nonbankrupt party to such contracts may terminate them on the basis of an ipso facto clause.

HeinOnline -- 38 Wayne L. Rev. 1395 1991-1992

reject an executory contract is not noteworthy. In deciding whether section 365 should apply to a letter of credit, the pertinent policy issue is whether letters of credit are the sort of things that section 365 affirmatively excludes from the estate. As will be discussed, application of section 365 depends less on whether letters of credit are deemed "executory" than on whether the costs of dealing with a bankruptcy trustee (credit and other risks) are the types of costs that the Bankruptcy Code imposes on nonbankrupt parties to executory contracts.

Such a pragmatic approach, focusing on the effects of classification rather than formalistic definitions, is consistent with the better trend in recent scholarship in the area of executory contracts. Although they have specific disagreements, Professors Westbrook and Andrew agree in general that the attempts to define "executoriness" have led to unnecessary complications and that "when rejection of a contract is at stake, the definition of an 'executory' contract should make no difference."[63] Westbrook would do away completely with any test for "executoriness,"[64] while Andrew would retain a simplified test as a precondition to assumption of an executory contract.[65] Similarly, where the issue is whether a trustee is barred from assuming a certain contract, the analysis should be on the policies underlying the exclusion of certain classes of contracts from bankruptcy estates, rather than on unnecessarily attempting to force the letter of credit into a jurisprudential framework that is already "hopelessly convoluted and contradictory."[66]

II. Whether a Letter of Credit is a Contract to Provide "Financial Accommodations" to the Beneficiary

In holding that a letter of credit is an executory contract to extend "financial accommodations" to the beneficiary debtor and therefore cannot be assumed by the trustee of the beneficiary's bankruptcy estate, *Swift Aire* relied upon the following statement of the legislative history: "Thus, under this provision, contracts such as loan commitments and letters of credit are nonassignable, and may not be assumed by the trustee."[67] The court did not

---

63. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1, 8 (1991).
64. *Id.* at 16, 28-31.
65. *Id.* at 28-31.
66. *Id.* at 1-2.
67. H.R. Rep. No. 595, 95th Cong., 1st Sess. 348 (1978).

HeinOnline -- 38 Wayne L. Rev. 1396 1991-1992

analyze the issue, but rather simply relied on the foregoing language. However, if the court had analyzed the issue, it could have reasonably concluded that a letter of credit is not a contract to provide "financial accommodations."

Standing alone, the letter of credit does not represent an extension of credit by the bank to the beneficiary. Even viewing the letter of credit as part of an overall transaction (i.e. considering the letter of credit running from the bank to the beneficiary, the relationship between the bank and the account party, and the underlying relationship between the account party and the beneficiary that resulted in the issuance of the letter of credit), a letter of credit would almost always be a device by which the account party *avoids* extending credit to the beneficiary. The relationship that is a commitment to extend credit is the bank's agreement to issue letters of credit and to seek reimbursement from the account party.

The phrase "financial accommodations," which appears often in loan contracts and guaranties, is not defined in the Bankruptcy Code. The phrase could be paraphrased as "extension of credit, by whatever means." A typical guaranty might read: "The word 'indebtedness' includes any and all advances, loans, or other financial accommodations, heretofore or hereafter granted by you to, or for the account of, Dealer."[68] By including the catch-all term "financial accommodations," the guaranty covers all extensions of credit, even if not technically "advances" or "loans." Thus, a guarantor cannot escape liability for a given extension of credit by contending that it was not technically an advance or loan.

The Bankruptcy Code uses the phrase with that general meaning to encompass all contracts to extend cash credit to the debtor: the trustee may not assume a "contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor."[69] Just as the phrase works as a catch-all to ensure that a guarantor cannot escape liability with technical arguments as to whether an extension of credit was a "loan," a

---

68. United States Home Acceptance Corp. v. Kelly Park Hills Inc., 542 So. 2d 463, 464 (Fla. App. 1989). For similar uses of the phrase, see Bank of Three Oaks v. Lakefront Prop. 178 Mich. App. 551, 557-58, 444 N.W.2d 217, 220 (1989); Yarbrough v. Maybee Bros. Lumber & Supply Co., 189 Ga. App. 299, 299, 375 S.E.2d 471, 472 (1988); Fronning v. Blume, 429 N.W.2d 310, 313 (Minn. App. 1988).

69. 11 U.S.C. § 365(c)(2).

HeinOnline -- 38 Wayne L. Rev. 1397 1991-1992

trustee cannot seek to force a nonbankrupt party to extend credit to the bankruptcy estate under an executory contract on the grounds that the particular type of credit sought is not technically a "loan" or "debt financing."

> The purpose of this subsection is to make it clear that a party to a transaction which is based upon the financial strength of a debtor should not be required to extend new credit to the debtor whether in the form of loans, lease financing, or the purchase or discount of notes.[70]

Thus, the trustee may not assume certain contracts[71] which extend credit to the debtor, and that by their nature make the other party dependent on the financial strength of the debtor.[72] Determining whether a letter of credit, either standing alone or as part of a larger transaction, is a contract to provide financial accommodations to the beneficiary requires an analysis of the allocation of risks and benefits in the letter of credit transaction.

The letter of credit is an elegant solution to a common problem in commercial life. A, to induce B to act, needs to provide assurance acceptable to B that B will obtain a certain payment

---

70. S. REP. No. 989, 95th Cong., 2d Sess. (1978).

71. Not all contracts to extend credit are included in § 365(e): it encompasses only "the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods or services with payments to be made over time. U.S. CODE CONG. & ADMIN. NEWS 6505, 6515 (1978) (statement by the Hon. Dennis Deconcini). Indeed, in most contracts where the exchange of performance is not simultaneous, the party that performs first relies on the financial strength of the other to be able to finance its performance. For example, contracts to provide goods or services without requiring immediate payment do not fall within § 365(b)(2). *See* 2 COLLIER ON BANKRUPTCY § 365.05 at 365-44 (15th ed. 1988). Thus, a seller might be obliged to deliver a truckload of widgets to a debtor and hope for payment of the invoice in thirty days, while a bank that promised to make a short-term loan to pay for the widgets will be excused. This is one reason that a seller might require a letter of credit. *See also In re* United Press Int'l, Inc., 55 Bankr. 63 (Bankr. D. Col. 1985) (lessor expending money to prepare leased premises for debtor's tenancy did not make it a contract to extend financial accommodations, i.e., a contract to extend accommodations is not a contract to extend financial accommodations). A broader reading of the provision makes it applicable to executory contracts under which the non-bankrupt party must deliver money or other property in exchange for a promise to pay. *See In re* Easebe Enter., 900 F.2d 1417 (9th Cir. 1990).

72. *See, e.g.*, Continental Experts Enter. v. Stowers, 26 Bankr. 308 (Bankr. S. D. Fla. 1982) (unfunded portion of construction loan); *In re* New Town Mall, 17 Bankr. 326 (Bankr. D.S.C. 1982) (loan commitment).

HeinOnline -- 38 Wayne L. Rev. 1398 1991-1992

upon fulfilling certain conditions. A is willing to make the payment, but only with assurance that payment will be made only if the conditions are met. To take the paradigmatic example, the traditional use of a letter of credit involved a sale of goods between merchants in different cities.[73] The seller did not want to ship goods without assurance that payment would be made. The buyer did not want to pay for the goods without assurance that shipment had been made. There are various means of assuring payment without making it in advance: taking collateral, finding out enough about the buyer to be comfortable that payment will be made, having a third party guaranty that the buyer would pay, relying on the enforcement procedures available under the law, or trusting the buyer. The letter of credit offered another alternative, under which a bank, or banks in both cities acting in tandem, assumed the risks. A, the buyer, would arrange for the bank to promise to pay B, the seller (or B's bank), upon the fulfillment of predetermined conditions. B, or at least B's bank, trusted A's bank enough to perform in reliance on the letter of credit for payment. If properly compensated, A's bank was willing to undertake making the payment, but not if it had to incur the costs of becoming enmeshed in the merits of the underlying transaction. Disbursing money is part of a bank's business; counting and inspecting goods is not. To restrict the bank's role to banking, the letter of credit defined the conditions for payment to require the bank to do only relatively simple things within its area of expertise, such as examining specified documents, including the bill of lading which B would receive upon shipping the goods to A. The use of letters of credit, of course, did not remain restricted to sales of goods for very long. Because the letter of credit provides an efficient way for parties, whether parties to a commercial transaction or persons linked in any of the many ways modern commercial life throws entities together, to reduce the amount of trust they have to place in each other, letters of credit are being used more frequently and in more ways.

Thus, a letter of credit is simply a promise, or an "engagement,"[74] made by the bank at the behest of the account party, A in the transaction above, to pay the beneficiary, B in the transaction above, conditioned only on the presentation of specified

---

73. *See, e.g.*, Kozolchyzyk, *supra* note 30, at 24 (1966); Dolan, *supra* note 28, at 3; Miller, *Problems and Patterns of the Letter of Credit*, 1959 U. ILL. L.F. 162, 162-66; Comment, *supra* note 26, at 135-38.

74. U.C.C. § 5-103(a)(1).

HeinOnline -- 38 Wayne L. Rev. 1399 1991-1992

documents or drafts. The account party is obliged to reimburse the bank if the bank makes payment to the beneficiary. Frequently, the bank will require the account party to provide security to ensure reimbursement, such as a lien on property of the account party. For example, in a "back-to-back" letter of credit, a bank takes an assignment of the proceeds of a letter of credit as security for the issuance of another letter of credit for the account of the beneficiary of the first letter of credit. More frequently, a bank will issue letters of credit, pursuant to a general loan agreement with an account party, that provide for other extensions of credit (such as advances to the client) and is secured by liens on various assets of the client.

The key to the letter of credit is the "independence principle." The issuing bank promises only that it will pay the beneficiary if the terms of the letter of credit are met. It does not promise to pay if the underlying right to payment is earned.

> Credits, 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.[75]

Thus the beneficiary cannot contend that, by performing the underlying contract, it is entitled to payment from the bank under the letter of credit. Only by producing the required documents does the beneficiary have the right to payment from the bank.

> In credit operation all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate.[76]

---

75. Uniform Customs, *supra* note 26, Art. 3. U.C.C. § 5-109 states the same principle in somewhat different form:

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

76. Uniform Customs, *supra* note 26, Art. 4.

HeinOnline -- 38 Wayne L. Rev. 1400 1991-1992

> A beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the applicant for the credit and the issuing bank.[77]

In the same vein, the account party cannot prevent payment under the letter of credit by contending that the beneficiary has not performed under the underlying contract.[78]

Functionally, under the independence principle, each of the parties surrenders the right to rely on the other parts of the overall transaction with regard to payment under the letter of credit. The bank, vis-a-vis the beneficiary, is unable to avail itself of set-offs that it has against the account party, as it would under other

---

77. *Id.* Art. 6.

78. However, a court may enjoin the bank from honoring a draft if a document presented by the beneficiary "is forged or fraudulent or there is fraud in the transaction." U.C.C § 5-114(2). "Fraud" is a word that is difficult to define and has been used in many different ways. Accordingly, there has been considerable argument about the issue, under what circumstances honor of a letter of credit may be enjoined on the basis of "fraud." In addressing the proper limits of the provision, commentators have looked more to policy arguments regarding the uses of the letter of credit than to the meaning of the word "fraud," with varying conclusions. *See, e.g.*, Dolan, *supra* note 28 (arguing that to protect the independence principle, fraud in the transaction cannot be understood to include fraud in the underlying transaction); Mautner, *Letter-of-Credit Fraud: Total Failure of Consideration, Substantial Performance and the Negotiable Instrument Analogy*, 18 L. & POL'Y INT'L BUS. 579 (1986) (arguing that for letters of credit used for "commercial credit transactions," total failure of consideration should constitute fraud in the transaction, whereas for standby letters of credit, failure to make substantial performance should suffice); Comment, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 246 (1985) (arguing that because the letter of credit shifts the risk of unjustified demand from the beneficiary to the account party, "fraud in the transaction for standby letters of credit should be narrowly defined to require that the customer have no adequate alternative remedy and that there be no reasonable basis for the beneficiary's demand"). The *Swift Aire* court did not address an argument raised by the bank in that case, that the proposed draw was fraudulent because the certification recited that funds from the draw were required by Swift Aire for continued operation of the business, whereas the business was actually being liquidated.

Note that the "fraud exception" is not an exception to the independence principle, which is viewed as a means of facilitating specialization of tasks, as discussed below, because it leaves the onus of monitoring the underlying contract on the account party, not on the bank. Under U.C.C § 5-114, the bank is permitted to honor a draft in good faith even despite notice of fraud and thus is not required to monitor or decide disputes with respect to the underlying contract. Rather, the onus is on the account party to get an injunction.

HeinOnline -- 38 Wayne L. Rev. 1401 1991-1992

arrangements.[79] The account party, with regard to the bank's demand for reimbursement, surrenders its right to insist on performance under the underlying contract before payment on the letter of credit. The beneficiary gives up the right to demand payment from the bank by substantially performing the underlying contract. It must produce the specific required documents.

The net economic effect is that each party is assigned the roles within its specialty. The bank acts as the trustworthy deep pocket, which assures the beneficiary that its fulfillment of the conditions of the letter of credit will result in payment.[80] The bank also monitors the creditworthiness of the account party and adjusts the fee charged and the security required accordingly. The beneficiary performs the task for which expertise[81] the account party has sought it out (or, more generally, provides whatever it is that the account party is willing to "buy" with the letter of credit).[82] The

---

79. *See* J. WHITE & R. SUMMERS (2d ed. 1980), *supra* note 43, § 18.2 at 711. For example, under U.C.C. § 9-318, the rights of an assignee of an account are subject to all the terms of, and defenses and claims arising out of, the underlying contract, and to any other defense or claim accruing before the account debtor receives notification of the assignment.

80. *See* Justice, *Letters of Credit Expectations and Frustrations-Part 1*, 94 BANKING L.J. 424, 428-29 (1977); Note, *Letters of Credit: the Role of Issuer Discretion in Determining Documentary Compliance*, 53 FORDHAM L. REV. 1519, 1519 & n.2 (1985). In addition to appearing to be sufficiently solvent and reliable to satisfy the beneficiary, the bank's role was often important simply as a dependable method for a buyer in one place to make payment to a seller in another place, which might be in another country. This aspect is of less importance when considering the expanded uses of letters of credit involving transactions within one city.

81. *See* McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 OHIO ST. L.J. 1197 (1989) (discussion of whether certain areas of expertise should not be fostered by the letter of credit).

82. This aspect may be reversed with regard to other uses of the letter of credit where the beneficiary may be the buyer and requires a "standby" letter of credit to be posted as a form of guaranty of performance on liquidated damages. *See* J. DOLAN, *supra* note 47, at 3 n.5. When the seller (or the party that provides a service such as a construction contractor) is the account party, then its primary role is still to perform the expertise for which the other party contracted. But it does so, not in order that the conditions under a letter of credit be triggered, but rather to avoid the condition under a letter of credit being triggered. Some transactions are structured with mirror letters of credit, one each for the account of each party naming the other as beneficiary, whereby the seller obtains payment under one letter of credit by performing, but permits the buyer to draw on the other letter of credit if the seller failed to perform. *See* Note, *supra* note 26, at 174 n.16.

HeinOnline -- 38 Wayne L. Rev. 1402 1991-1992

beneficiary and the account party together[83] define the conditions in the letter of credit. To do so, the two parties draw on their knowledge of both the relevant business and the other factors surrounding the transaction. The parties then determine the nature of the risk-allocating provisions. In all transactions the account party has the final task of reimbursing the bank.

Thus, a letter of credit, whether regarded alone or as part of a larger transaction,[84] is not a device to extend credit to the

---

83. The letter of credit, particularly the standby letter of credit, has been characterized as shifting the risk of unjustified demand for or refusal of payment from the beneficiary to the account party. *See* Comment, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218 (1985). The extent to which the risk is shifted will depend on how the conditions for drawing under the letter of credit are defined. In addition, careful drafting of the conditions serves to reduce the total risk of litigation claiming unjustified demand or refusal. *Id.* at 224-25 n.41.

84. For examples of the many possible uses of the letter of credit (many but not all of which could be called standby letters of credit), see J. WHITE & R. SUMMERS (2d ed. 1980), *supra* note 43, § 18-1, at 708-09; Baird, *supra* note 2, at 135-38; Baron, *Debt Supported by Irrevocable Letters of Credit, Irrevocable Commitments and Note Purchase Agreements*, FIXED INCOME INVESTOR 553 (June 21, 1980); J. DOLAN, *supra* note 28, at 2-7 & n.11 (citing instances of standby letters of credit used for sale of trucks, silver futures contracts, equipment leases, repurchase agreements, and promissory notes) and at 6-7 (citing letters of credit used to support tax shelter investments); Gable, *supra* note 18, at 910-14 (describing letters of credit used "with increasing frequency in a variety of situations other than documentary sales"); Gorman, *Standby Letters of Credit and Guaranties; Do We Understand What We're Doing?*, J. COM. BANK LENDING (April 1978); Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C. L.J. 251 (1971); Joseph, *Letters of Credit; The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816 (1977); Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 324 (1982) (citing study that thirty-five billion dollars of standby letters of credit were issued in the first quarter of 1980); McLaughlin, *supra* note 2, at 1039-40; Murray, *Letters of Credit in Nonsale of Goods Transactions*, 30 BUS. LAW. 1103 (1975); Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 717 n.7 (1973) (noting, among other uses, that letters of credit were used to finance the release of Bay of Pigs prisoners); Weill, *Comparison of Letters of Credit and Insurance Policies as Credit Enhancement Techniques*, 450 PLI/Comm. 583, PLI Order No. A4-4216 (PLI 1988); Wheble, *"Problem Children"—Stand-by Letters of Credit and Simple First Demand Guaranties*, 24 ARIZ. L. REV. 301 (1982); Note, *The Application of Compulsory Joinder, Intervention, Impleader and Attachment to Letter of Credit Litigation*, 52 FORDHAM L. REV. 957, 960-62 & n.11 (1984) (citing instances where letters of credit used to secure interim lenders, as security for litigation bond, to secure permanent financing, to guarantee salary payments as substitute for working capital deposit, to guarantee performance of debt securities, and to support issuance of commercial

HeinOnline -- 38 Wayne L. Rev. 1403 1991-1992

beneficiary.[85] Standing alone, the letter of credit does not represent an extension of or a commitment to extend credit by the bank to the beneficiary. It is an obligation to pay the beneficiary upon presentation of certain documents, and the bank does not depend on the creditworthiness of the beneficiary. Unlike disbursement of a loan, payment under a letter of credit does not create an obligation on the part of the recipient of the funds to repay the bank.[86] Rather, by issuing a letter of credit, a bank extends credit to the account party, who must reimburse the bank if the beneficiary draws on the letter of credit.

Even if regarded as part of the overall transaction, the letter of credit is *not* intended to rely on the financial strength of the beneficiary. An account party typically provides a letter of credit as an incentive to induce the beneficiary to extend credit to the account party, either by performing before receiving payment or otherwise agreeing to depend on the payment of the letter of

---

paper by a corporate borrower); Comment, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L. L.J. 189 (1980); Note, *"Fraud in the Transaction:" Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992 (1980); Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 613 & n.123 (1979) (citing instances of usage for appeal bond, as proof of financial responsibility, and payment of loan commitment fees); Comment, *supra* note 26, at 149-54 (citing uses for construction contracts, for "floor-planning" trust-receipt financing, and for guarantee of lease payments); *see also*, Note, *The Standby Letter of Credit and the Unsecured or Underliquidated Damages Clause*, 9 U. BRIDGEPORT L. REV. 241 (1988); Kelly & Shultz, *". . . Or Other Adequate Security': Using, Structuring, and Managing the Standby Letter of Credit to Ensure the Completion of Subdivision Improvements*, 19 URB. LAW. 39 (1987); Lord, *The No-Guaranty Rule and the Standby Letter of Credit Controversy*, 96 BANKING L.J. 46 (1979); Note, *Standby Letters of Credit-True Letters of Credit or Guaranties: Republic National Bank v. Northwest National Bank*, 33 S.W. L.J. 1301 (1980); Note, *The Role of Standby Letters of Credit in International Commerce; Reflections After Iran*, 20 VA. J. INT'L. L. 459, 467 (1980) (standby letters of credit with a face value of over 250 billion dollars were outstanding in the United States as of 1986). McLaughin, *On the Periphery of Letter-of-Credit Law: Suffering the Rigors of Strict Compliance*, 106 BANKING L. J. 4 (1989).

85. *See* Leary & Ippoliti, *Letters of Credit: Have We Fully Recovered From Three Insolvency Shocks*, 9 U. PA. J. INT'L BUS. L. 595 (1987) (summary statement on the first point).

86. If a letter of credit were a contract to extend financial accommodations to the beneficiary, then a guaranty would be a contract to extend financial accommodations to the obligee. There would be no reason for a guarantor to be relieved of its obligations simply by the happenstance of the obligor's bankruptcy, particularly in light of the fact that the underlying obligation would likely remain in place or be assumed by the obligee.

HeinOnline -- 38 Wayne L. Rev. 1404 1991-1992

credit. The letter of credit is effective as an incentive to beneficiaries because the extension of credit by the beneficiary is short-term, if the beneficiary can draw directly after performing, and the letter of credit makes the transaction less risky by providing a sure means of payment from a dependable source. For example, in the typical sales transaction, the buyer posts a letter of credit precisely to avoid paying in advance. Similarly, where a letter of credit is used in connection with the payment of continuing obligations in the sale of a business, it is used to avoid making such payments up front by adjusting the purchase price. Likewise, where a standby letter of credit is used to guaranty obligations of the account party running to the beneficiary, the conditions, if artfully drawn, will permit the beneficiary to draw on the letter of credit only when it is entitled to the proceeds.

Payment under a letter of credit in some circumstances could create an obligation on the part of the beneficiary to return proceeds to the account party, but not as an extension of credit. First, the beneficiary could wrongfully draw on the letter of credit when it was not entitled to the funds. Second, the letter of credit, by its terms, could entitle the beneficiary to draw before it was entitled to the funds pursuant to the underlying transaction. This could occur because the letter of credit is unartfully drafted, or drafted more to the liking of the beneficiary rather than the account party, or because of unforeseen intervening events. In these ways, a letter of credit could be part of an overall arrangement that in effect extends credit to the beneficiary. However, the risks of fraudulent draws or unartfully drafted letters of credit are not credit risks dependent on the financial strength of the debtor; instead these risks are based on the integrity of the trustee.[87] While a trustee may seek to recover under the letter of credit by presenting non-complying documents or attempt to wrongfully retain proceeds, these are not the sort of risks that section 365(c)(2) is designed to guard against; such risks would exist equally with other kinds of executory contracts.

Finally, a letter of credit could be used as a funding mechanism where the account party has a separate executory contract to provide financial accommodations to the beneficiary. Such a situation existed in *Swift Aire*. My position is not that *Swift Aire* necessarily reached the wrong result, but rather that the *Swift Aire*

87. *See.* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 19-9 at 76 (3d ed. 1988).

court looked at the wrong issues and applied an unfounded rule. Application of such a rule to other cases would lead to the wrong results in the vast majority of cases.

In *Swift Aire* the letter of credit had been provided pursuant to an investment agreement in which the majority stockholder of the debtor agreed to contribute funds in the form of loans or the purchase of stock upon determination by the board of directors of the debtor that such funds were required to continue operations.[88] Thus, the debtor could draw on the letter of credit only pursuant to the separate contract, thereby effectively assuming the contract. The court's analysis should have focused on whether the separate contract was assumable. In cases like *Swift Aire*, if assumption of the separate contract would violate section 365, the appropriate form of relief should be an order to prevent a draw or to return proceeds of a wrongful draw.[89] Thus, *Swift Aire* may[90] have arrived at the right result by the wrong route, setting a dangerously overbroad precedent on the way.

There remains the legislative history, which states that contracts such as letters of credit may not be assumed by the trustee. This history was interpreted by *Swift Aire* to bar assumption of an outstanding letter of credit by the beneficiary.[91] A different understanding, however, squares the statement with the discussion above. A letter of credit is not a means to extend credit to the beneficiary. The issuance of a letter of credit is, however, a means

---

88. *Swift Aire*, 30 Bankr. at 491.

89. Analyzing the separate agreement to see whether it is an executory contract to provide financial accommodations that are to be funded by a letter of credit would not violate the independence principle. Such analysis would not require a bank to take inappropriate action (i.e., monitor whether the separate agreement was assumable or not), because the bank would neither have standing to object, nor be subject to a stay order. Only the account party could claim that it was being asked to provide a loan through the letter of credit. The account party would not be able to circumvent the independence principle to prevent payment under the letter of credit for alleged failure to perform under the underlying contract, at least to any amount in excess of the interference with an underlying executory contract required by the Bankruptcy Code.

90. The result in *Swift Aire* might not be correct for the minority of cases that involve a separate contract to provide financial accommodations. Where, as in *Swift Aire*, the parties to the separate contract are not just the debtor and the potential creditor, but also other interested parties, an argument could be made that the obligation to the other parties to lend money to the debtor should be negated by § 365, for the bankruptcy of the debtor should not affect obligations running between third parties.

91. *Swift Aire*, 30 Bankr. at 496.

HeinOnline -- 38 Wayne L. Rev. 1406 1991-1992

to extend credit for the benefit of the account party. Where a debtor has a contractual arrangement with a bank whereby the bank is committed to issue letters of credit for the account of the debtor, the debtor's trustee in bankruptcy should not be permitted to assume such agreement and require the bank to issue further[92] letters of credit for the debtor's account.[93] That would be effectively the same as requiring the bank to make new loans to the debtor.

In light of the above analysis, the legislative history would make economic sense and conform to the purposes of section 365 if it read simply "loan commitments and commitments to provide letters of credit" instead of "loan commitments and letters of credit." This apparent mistake in drafting the legislative history is similar to the drafting mistake in the statute itself documented in *Shine v. Shine*.[94] The original draft of section 523(a)(5) made dischargeable "any liability to a spouse or child for maintenance or support, for alimony due or to become due, *or under a property settlement* in connection with a separation agreement or divorce decree."[95] The version that emerged from the Senate committee applied to "any liability to a spouse or child for maintenance or support, or for alimony due or to become due, in connection with a separation agreement or divorce decree."[96] The latter is the same as the original draft, except that the five words italicized in the first version were somehow deleted. The statute as enacted read, "to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree, or property settlement agreement."[97] This restored the reference to a

92. The bank will be bound to the beneficiaries with respect to letters of credit already issued.

93. *Accord In re* Adana Mortgage Banking Inc., 12 Bankr. 977, 987 (Bankr. N.D. Ga. 1980) (Government National Mortgage Association agreements guaranteeing mortgage-backed securities issued by debtor mortgage banker were nonassignable executory contracts to extend financial accommodations on behalf of the debtor); *In re* Wegner Forms Co., 49 Bankr. 440 (Bankr. N.D. Iowa 1985) (debtor's grain dealer's surety bond was executory contract to provide financial accommodations); *but see In re* Government Sec. Corp., 101 Bankr. 343, 345 (Bankr. S.D. Fla. 1989) (Securities Dealer Blanket Bond issued to debtor was not an executory contract).

94. 802 F.2d 583 (1st Cir. 1986). I am indebted to Phil Frickey for this point.

95. *Id.* at 586.

96. *See Shine*, 802 F.2d at 587.

97. 11 U.S.C. § 523(a)(5) (1988 & Supp. II 1991).

HeinOnline -- 38 Wayne L. Rev. 1407 1991-1992

property settlement agreement, but placed the reference at the end of the provision. Rather than reading the statute literally, which would lead to a strange result, the *Shine* court applied the intent of the original version.[98] The statute was also amended to clarify the accuracy of such a result. In the instant case, the legislative history, not the statute itself, is apparently wrong. The words and intent of the statute, supported by the other elements of the legislative history, should have controlled the unfortunate wording in the legislative history, which was probably the result of both the "harried and hurried atmosphere"[99] of the process of enacting the Bankruptcy Code, and the fact that the fine distinctions of letter of credit law often escape nonspecialists.

III. Whether Nonbankruptcy Law Bars Nonconsensual Transfer

In addition to relieving parties from obligations to lend money to bankrupt entities, the Bankruptcy Code spares certain parties to executory contracts from other risks of doing business with the trustee. The trustee may not assume or assign an executory contract if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession whether such contract, or lease, prohibits or restricts assignment of rights or delegation of duties."[100] In short, the trustee may not assume that a contract is nontransferable under nonbankruptcy law, where nontransferability arises from the law and not from a restriction in the contract itself.

98. *Shine*, 802 F. 2d at 588.

99. *Id.* at 587. Indeed, § 365(c), on its face, shows evidence of hurried work in the superfluous inclusion of the qualification "whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties" in both the body of § 365(c) and the sub-section modifying that provision, § 365(c)(1)(A). 11 U.S.C. § 365(c) (1988 & Supp. II 1991).

100. 11 U.S.C. § 365. Oddly, the language "whether or not such contract, or lease, prohibits or restricts assignment of rights or delegation of duties" appears twice in the same sentence. It first appears in the main clause of § 365(c), and then again in the conditional clause in § 365(c)(1)(A). The sentence therefore reads in simplified form: "Whether or not such contract prohibits assignment, the trustee may not assume it if applicable law excuses the other party from rendering performance to the trustee, whether or not such contract prohibits assignment." This is apparently the unintended result of redrafting the section, rather than an unusual way to emphasize the language. The Senate Committee notes indicate that § 365(c)(2) was previously drafted as § 365(b)(4).

HeinOnline -- 38 Wayne L. Rev. 1408 1991-1992

A. Whether the Rules on Consensual Transfer Bar Nonconsensual Transfer

Under both the Uniform Customs[101] and Article 5 of the Uniform Commercial Code,[102] whether a bank may transfer a letter of credit depends solely on whether the letter of credit expressly provides for transferability. Transfer of a letter of credit to a new beneficiary is effective only if the letter of credit is expressly designated as transferable.[103] Thus, where a letter of credit is silent on the issue of transferability, it may not be transferred. The trustee may not assume an executory contract that is nontransferable under applicable law, "independent of any restrictive language in the contract or lease itself."[104] Literally read, this would apply to a letter of credit, which is nontransferable independent of "restrictive" language in the letter of credit itself, because a letter of credit is transferable only if there is permissive language.[105]

The rules governing consensual transfer, however, do not exhaust "applicable law." The fact that a letter of credit may not be consensually transferred unless it so provides does not mean

101. Uniform Customs, *supra* note 26, Art. 54.

102. U.C.C. § 5-116(2)(a) (1990).

103. *See* Uniform Customs, *supra* note 26, Art. 54; U.C.C. § 5-116(1). The right to receive the proceeds of the letter of credit, however, may be assignable, even if the letter of credit expressly states that it is nontransferable or nonassignable. Uniform Customs, *supra* note 26, Art. 55; U.C.C. § 5-116(2).

104. 124 Cong. Rec. H11093 (Sept. 28, 1978); S17049 (Oct. 6, 1978).

In *In re* Braniff Airways, 700 F.2d 935 (1983), the trustee was unable to assign landing slots at Washington National Airport because FAA regulations required the approval of the Airport Manager for any commercial activity at the Airport. These regulations were deemed applicable law excusing the FAA from accepting performance from anyone other than the lessee. *Id.* at 942.

105. This provision has been held applicable to a partnership agreement. "[The present agreement] is a contract based upon personal trust and confidence. Under applicable nonbankruptcy law, the limited partners in a limited partnership do not have to accept substituted performance from a general partner other than the one with whom they have contracted." *In re* Harms, 10 Bankr. 817, 821 (Bankr. D. Colo. 1981). The same concerns should not bar transfer of a letter of credit to a trustee. As discussed below, the trust placed in the beneficiary of the letter is that it will not seek to fraudulently draw on it. The trustee may be presumed to be no more likely to do this than the beneficiary. No confidence is placed in the beneficiary's ability to perform, because the bank that issues the letter is not harmed by a failure to draw on it.

Contracts to make loans or extend other financial accommodations to the debtor were actually considered one form of "personal" contract that could not be assumed or assigned. *See* 2 COLLIER ON BANKRUPTCY § 365.05[1], at 365-45 (15th ed. 1979). Under this construction § 365(c)(2) could be seen as superfluous.

HeinOnline -- 38 Wayne L. Rev. 1409 1991-1992

that the bank may not be required to accept performance from a person other than the beneficiary. Courts have consistently held that the rights of a beneficiary under a letter of credit pass by operation of law to a successor in interest, such as the liquidator of an insurance company,[106] the sole shareholder as distributee of the assets of the dissolved beneficiary corporation,[107] or the Federal Deposit Insurance Corporation (FDIC) as receiver of a bank, which could then sell the letter of credit to the FDIC in its corporate capacity.[108] Applicable law thus does not excuse the issuer of a letter of credit from accepting performance from a person other than the beneficiary.

The reason for the presumption against consensual transferability does not apply to a nonconsensual assignment of rights to a trustee in bankruptcy by operation of law. As discussed, the reason for the presumption is that banks, and indirectly account parties, might otherwise be exposed to the risk of strangers wrongfully drawing under the credit. The presumption against transferability is intended to prevent a bank from being forced to rely upon strangers to the transaction, rather than upon the beneficiary

---

106. Pastor v. National Republic Bank of Chicago, 76 Ill. 2d 139, 390 N.E.2d 894 (1979). The court thus ignored the independence principle by looking at whether the right to payment had been earned under the underlying contract. The court expressly left open what it considered the harder and broader question of "whether there can be a complete transfer of all incidents of a letter of credit by operation of law." *Id.* at 149-50, 390 N.E.2d at 898. *Accord* Eakin Fidelity v. Continental Ill. Nat'l. Bank & Trust Co., 687 F. Supp. 1259, 1261 (N.D. Ill. 1988) (same holding under Illinois law); Cris v. J. Henry Schroder Bank & Trust Co., 693 F. Supp. 1429 (S.D.N.Y. 1988) (same holding under New York law).

107. Temple-Eastex Inc. v. Addison Bank, 672 S.W.2d 793 (Tex. 1984) (relying on TEX. BUS. CORP. ACT ANN. art. 6.04 (Vernon 1980)). The court also relied on the Texas statutory provision governing claims against dissolved corporations:

> [T]he dissolution of a corporation . . . shall not take away or impair any remedy available to or against . . . its . . . shareholders, for any right or claim existing . . . prior to such dissolution. The *shareholders* . . . shall have power to take such *corporate or other action* as shall be appropriate to protect such remedy, right, or claim (emphasis and ellipses provided by the court).

672 S.W.2d at 796 (quoting TEX. BUS. CORP. ACT ANN. art. 7.12 (Vernon 1980)).

108. FDIC v. Bank of Boulder, 911 F.2d 1466 (10th Cir. 1990). The court, on rehearing en banc, held that both 12 U.S.C. § 1823(c)(2)(A) (1988), which authorizes the FDIC to purchase any assets of the failed bank, and federal common law operated to preempt prohibitions on transfer under state law or the terms of the letter of credit.

HeinOnline -- 38 Wayne L. Rev. 1410 1991-1992

in which the bank reposed confidence.[109] The rule seeks also to protect the account party from untrustworthy strangers: "If 'assignment of the credit' includes delegation of performance of the conditions under the credit, then the initiating customer, who in many cases has put its faith in performance or supervision of performance by a beneficiary of established reputation, may be deprived of real and intended security."[110] However, permitting the trustee to succeed to the rights of the debtor should not increase the risk of a dishonest attempt to draw under the letter of credit. The Bankruptcy Code must assume that the trustee is more upright than the debtor. For example, one ground for seeking appointment of a trustee in a Chapter 11 case is fraud by the debtor.[111] Moreover, the fact that the right to draw passes to the trustee would not delegate performance under the underlying contract to the trustee. Thus, to the extent that the account party is entitled to protection for its reliance on performance of that contract by the beneficiary, the question would properly be whether that contract could be assumed, not the letter of credit.[112]

---

109. *See, e.g.*, J. DOLAN, *supra* note 47, § 10.03[1] at 10-8:

> These cases reflect the common law's concern that the issuer not be compelled to rely on anyone other than the person to whom the issuer addresses the credit. The credit engagement is usually conditioned on the presentation of documents, and documents are easy to forge. The courts assumed that an issuer that promised to pay against easily forged documents reposed confidence in the integrity of the named beneficiary. By restricting the transfer of the credit, these cases are preventing a party in whom the issuer did not explicitly repose confidence from realizing on the credit engagement. Modern credit law continues these restrictions. Section 5-116 of the Code and Article 46 of the Uniform Customs limit transfer of the right to draw.

For a criticism of the analogy of tendering documents to performance and of the separation of the right to draw from the right to receive proceeds, see Eberth & Ellinger, *Assignment and Presentation of Documents in Commercial Credit Transactions*, 24 ARIZ. L. REV. 277, 295-99 (1982).

110. U.C.C. Official Comment to § 5-116 (1987).

111. If the debtor, rather than a trustee, is in possession, then the bank in fact and in law is dealing with the same person. In addition, a debtor should only be left in possession if she is considered trustworthy: "[T]he willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'" Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985), (*quoting* Wolf v. Weinstein, 372 U.S. 633, 651 (1963)).

112. Because the analysis would center on the separate contract, a court would not be required to decide on the thorny issues of whether a letter of credit itself is a "contract," and whether it is "executory."

HeinOnline -- 38 Wayne L. Rev. 1411 1991-1992

B. Whether the Rule of Strict Compliance Bars Transfer

The *Swift Aire* court effectively[113] held that a letter of credit was nontransferable due to the combined effect of the rule of strict compliance and the proposition that the filing of a bankruptcy petition terminates the corporate existence of the debtor corporation.[114] In *Swift Aire*, a draw under the letter of credit required a certification by the beneficiary corporation's secretary.[115] However, the trustee presented a draft signed by himself, not the corporate secretary.[116] The court upheld the bank's refusal to honor the draw, holding that the draft was insufficient under the doctrine of strict compliance, and that the trustee could not have produced a complying draft because the bankruptcy effectively terminated the debtor corporation's existence.[117]

A majority of courts follow the doctrine of "strict compliance," which requires a bank to honor a draw only if the proffered documents comply literally and exactly with the conditions set forth in the letter of credit.[118] The doctrine is a corollary to the independence principle and the specialization of tasks. The bank need not look to the underlying contract to determine if the conditions for drawing under the letter of credit are met. If the documents presented do not comply exactly with the terms of the

---

113. *Swift Aire* analyzed the issue strictly under state law terms, without considering whether specific provisions of the Bankruptcy Code would override a state law result effectively excluding the letter of credit from the estate.

114. *See supra* note 13 and accompanying text.

115. 30 BANKR. at 491.

116. *Id.*

117. *Id.* at 495-96.

118. *See* Dolan, *Strict Compliance with Letters of Credit: Striking a Fair Balance*, 102 BANKING L.J. 18 (1985) (discussion of the strict compliance rule). *See also* H. HARFIELD, *supra* note 48, at 241; Note, *Letters of Credit: A Solution to the Problem of Documentary Compliance*, 50 FORDHAM L. REV. 848 (1982). *See, e.g., In re* Coral Petroleum, 878 F.2d 830 (5th Cir. 1989) (strict compliance was required even where an inconsistency in the terms of the letter of credit made strict compliance impossible). The degree to which the proffered documents comply with the terms of the credit is the most important question of letter of credit law not addressed by the U.C.C. or Uniform Customs. *See* Note, *supra* note 42, at 1522-23. The requirement of strict compliance has been criticized as leading to inequitable results where the beneficiary has performed as required under the underlying contract but has not obtained documents strictly complying with the terms of the letter of credit. *Id.* However, inquiry should be made as to whether it would be more efficient for banks to determine whether proffered documents are "good enough" or for beneficiaries to see that the terms of the letter of credit are defined so that they can be met (as the beneficiary in *Coral Petroleum* should have).

HeinOnline -- 38 Wayne L. Rev. 1412 1991-1992

credit, the bank is not required to determine if the beneficiary should nevertheless be paid, because the beneficiary performed the task it was hired to accomplish.

However, the *Swift Aire* court makes too much of the strict compliance rule. Strict compliance is a means to facilitate the independence principle. Because the bank does not need to concern itself with the underlying contract, it should not have to determine whether the tendered documents are "good enough." The beneficiary either complies or not. Banks should not have to understand the business underlying each contract. However, banks should know basic matters of bankruptcy law, such as the fact that a trustee will step into the shoes of the debtor. The independence principle spares the bank the need to monitor the underlying contract, but it should not spare the bank the need to decide who the beneficiary is. Just as the bank is required to determine if the person that appears with a draft under the letter of credit is indeed who the person appears to be, the bank should know the basic bankruptcy rules. The bank deals with the trustee as the successor to the other party to the letter of credit, not as a party to the underlying contract. The bank is permitted three days before it is required to honor a draw under a letter of credit.[119] This is ample time for the bank to confirm that the beneficiary has indeed gone into bankruptcy. Thus, a rule that presentation by the trustee is in compliance would not present the risk against which the rule guards, that is, entanglement in the merits of the underlying transaction.[120]

Indeed, the *Swift Aire* court went further than this in its discussion of *American Bell International v. Islamic Republic of Iran*.[121] The terms of the letter of credit in *American Bell* required presentation by the Imperial Government of Iran, Ministry of

---

119. U.C.C. § 5-112(1).

120. Without addressing the specific legal issues, Professor Jackson has concluded that the result in *Swift Aire* was contrary to his view of the primary purpose of bankruptcy law; to implement a hypothetical creditors' bargain. *See* T. JACKSON, *supra* note 58, at 98-100 (in *Swift Aire*, the best way to allow bankruptcy law to mirror state law would be to allow the bankruptcy trustee to draw on the letter of credit). Professor Hill has discussed whether the Bankruptcy Code should be interpreted to further contractarian or utilitarian policies. *See* Hill, *Bankruptcy, Contracts and Utilitarianism*, 56 MO. L. REV. 571 (1991). Because the *Swift Aire* result terminates the individual "contract" rights of the beneficiary without any apparent collective benefit, it would appear to be contrary to either approach.

121. 474 F. Supp. 420 (S.D.N.Y. 1979).

HeinOnline -- 38 Wayne L. Rev. 1413 1991-1992

War. As a result of the Iranian revolution, presentation was made by the Islamic Republic. The *Swift Aire* court endorsed the holding that the Islamic Republic was entitled to draw on the letter of credit, but distinguished the case on the basis that *American Bell* involved international law: "American courts have traditionally viewed contract rights as vesting not in any particular government but in the state of which that government is an agent."[122] The *Swift Aire* court ignored its prior reliance on the principle of strict compliance, as the draw in the name of the Islamic Republic obviously did not comply with the literal terms of the letter of credit. It is anomalous to require banks to be conversant with abstract notions of international law but not to require banks to be aware of the most basic principles of the Bankruptcy Code.

The *Swift Aire* court could simply have held that the particular draft presented in that case did not comply, without addressing the larger question of whether the trustee could produce a complying draft. The court, however, held categorically that the filing of the bankruptcy petition terminated the powers of the corporate secretary, stating:

> Swift's officers and directors have no power or authority to deal with the estate, its assets or its affairs. The trustee, only, is empowered to dispose of business assets, and when appropriate authority is obtained, to operate the business. By filing bankruptcy, Swift has made it impossible for Wells Fargo or Swift to draw against the letter of credit. Since there is no longer a corporate secretary able to act for the debtor, the statement required by the letter of credit cannot be signed by the designated individual.[123]

This holding was a broad expansion of the doctrine applied in some bankruptcy cases that a bankruptcy debtor is a "new juridical entity separate and apart from the prebankruptcy company."[124] Some courts employed the doctrine to explain the rule that a trustee or debtor in possession was entitled to assume or reject executory contracts to which the debtor was party. If the bankruptcy estate was a new entity, it was not bound by executory

---

122. *Swift Aire*, 30 Bankr. at 490 (quoting *American Bell*, 174 F. Supp. at 423).

123. *Id.* at 495.

124. 5 COLLIER ON BANKRUPTCY § 1101.01, at 1101-3 (15th ed. 1979); *see also* cases cited therein; M.J. BIENENSTOCK, BANKRUPTCY REORGANIZATION 442

HeinOnline -- 38 Wayne L. Rev. 1414 1991-1992

contracts of the debtor unless they were assumed by the estate.[125] The decision of the Supreme Court in *NLRB v. Bildisco & Bildisco*[126] casts doubt on the vitality of the new entity doctrine. There the Court held that a debtor in possession was not a new entity, at least for the purposes of whether it was an "alter ego" or "successor employer" under federal labor law:

> For our purposes, it is sensible to view the debtor-in-possession as the same 'entity' which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have employed absent the bankruptcy filing.[127]

To use the terms of *American Bell*, *Bildisco* seems to say that the overthrow of the debtor by its creditors results in a new regime, but not a new state.

Even if the "new entity" doctrine is valid, *Swift Aire* reached a conclusion that does not follow from the doctrine. Indeed, a trustee could produce a complying certificate in at least one of two possible ways. *Swift Aire* interpreted the doctrine not just as earlier courts have, to say that the debtor was no longer a party to its executory contracts, but extended the doctrine to obliterate the prebankruptcy powers of the debtor corporation. The Bankruptcy Code, however, requires that such powers either pass to the trustee or abide with the debtor corporation. The survival of corporate powers is implicit in the Bankruptcy Code's empowerment of the trustee. Under section 1108, or under section 721 by order of the court, the trustee has the right to operate the debtor's business. Operation of a business requires documents to be appro-

---

& n.42 (1987). A minority of courts under the Bankruptcy Act relied on the "new entity" theory as one way to explain the rule that a trustee or debtor in possession could reject or assume executory contracts of the estate; these cases saw the estate as a "new entity" that was not bound by the debtor estate's contracts unless it assumed them. *See* Westbrook, *supra* note 58, at 235.

125. *See* Westbrook, *supra* note 58, at 235-36.

126. 465 U.S. 513 (1984). *See* Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AMER. BANKR. L.J. 197, 198-200 (1985).

127. *Bildisco*, 465 U.S. at 528. For a debtor in possession who was a general partner, unsuccessfully contending that it was a new entity not bound by the debtor's duty of good faith and fair dealing to other partners, see Washington Medical Center v. Holle, No. 88-1205 (D.C. Ct. App. May 3, 1990).

HeinOnline -- 38 Wayne L. Rev. 1415 1991-1992

priately executed. The trustee also, under section 363, has the power to use, sell, or lease property of the estate.[128]

If the powers of the trustee were held not to include the power to make certifications in the name of the debtor, then the trustee could require the debtor to execute a draw on behalf of the trustee. Although appointment of a trustee ousts the management from control of a debtor corporation, the premise of *Swift Aire* that a debtor not in possession because of bankruptcy becomes a powerless legal entity is contrary both to the Bankruptcy Code and to corporate law. Under section 521(3), the debtor must "cooperate with the trustee as necessary to enable the trustee to perform the trustee's duties." Under section 1142(b),[129] the court may direct the debtor to execute any instrument required to effect a transfer of property dealt with by a confirmed plan.[130] Either provision could require the debtor to execute a draw on the letter of credit for the benefit of the trustee. Bankruptcy alone does not render the corporation unable to take such action: "[T]he great weight of authority is to the effect that adjudication in bankruptcy does not dissolve a corporation nor suspend the right of the corporation to elect officers or take corporate action."[131] The fallacy of the *Swift Aire* position becomes most stark if the debtor is not a corporation but is an individual. Under *Swift Aire*, the individual would cease to exist as a legal entity.

Finally, *Swift Aire*'s application of the rule of strict compliance effectively makes the conditions of the letter of credit equivalent to anti-assignment clauses, which are negated by section 365. As set forth above, section 365 gives effect only to prohibitions against transfer that are contained in applicable law, without any regard to restrictive language in the executory contract itself. Applying strict compliance to make an otherwise assumable executory con-

---

128. *Cf.* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352 (1985) (outlining the extensive powers of a bankruptcy trustee).

129. 11 U.S.C. § 1142(b) (1988).

130. *Id.* The point may be made by taking the *Swift Aire* conclusion to its logical end. Under § 1141(b), confirmation of a plan vests all property not provided for in the plan in the debtor. If, as *Swift Aire* assumed, the letter of credit became property of the estate, it therefore would return to the debtor upon confirmation of a plan. The debtor could then execute a letter perfect draw, provided that the letter of credit had not expired in the meantime. Under *Swift Aire*, then, the right to draw simply goes into hibernation. This serves neither the goals of the Bankruptcy Code nor the letter of credit.

131. 15A W. FLETCHER, CYCLOPEDIA CORPORATIONS § 7657, at 772 (rev. perm. ed. 1990).

HeinOnline -- 38 Wayne L. Rev. 1416 1991-1992

tract nonassumable because of inability of the trustee to meet the specific conditions of the letter of credit would transform such terms within the contract into restrictions on transfer.

IV. Conclusion

I do not propose any amendment to the Bankruptcy Code provisions governing executory contracts to overrule the *Swift Aire* decision. Section 365 has already grown more than long enough with special provisions relating to leases of real property in shopping centers, leases of nonresidential real property, timeshare plans, and licenses of rights to intellectual property. Section 1167 further adds special rules for executory collective bargaining agreements. The problems with *Swift Aire* arose not from the language of the Bankruptcy Code, but from the fact that *Swift Aire* essentially disregarded the language in favor of some faulty legislative history and the court's own radical extension of the new entity doctrine. A court that fully addresses the issues is unlikely to repeat this mistake.

HeinOnline -- 38 Wayne L. Rev. 1417 1991-1992

HeinOnline -- 38 Wayne L. Rev. 1418 1991-1992