POWELL GOLDSTEIN LLP

Go beyond Go PoGo

Structuring Letters of Credit That Won’t Leave You Stranded in a Customer Bankruptcy

NACM’s 2008 Audio Teleconference Series

Monday, April 21, 2008

Robert M.D. Mercer, Esq.
Powell Goldstein, LLP
404.572.6976
rmercer@pogolaw.com

DISCLAIMER: The materials and information contained in this presentation are provided for informational purposes only and are not to be considered as legal advice. Transmission of the information is not intended to create, and receipt does not constitute, an attorney-client relationship between the presenter/author and participants. In addition, this presentation is not intended to be a comprehensive review of the subject matter.

1270868

What is a Letter of Credit?

A letter of credit is a two part, three party transaction.

The customer requests the issuing bank to agree to pay the trade creditor money under certain conditions.

In exchange, the customer pays a fee and agrees to reimburse the issuing bank for any money it pays to the trade creditor.

Often, to reduce its credit exposure, the issuing bank will require that the customer grant it a security interest in its assets to secure the customer's reimbursement obligation.

From a debtor-creditor standpoint, the goal is to isolate the trade creditor from the bankruptcy or financial insolvency risks of the customer. This concept is called the "independence principle."

Place the Bankruptcy Trigger in the Letter of Credit

The most important thing for you to know about letters of credit from a bankruptcy perspective is to make sure that the bankruptcy trigger is in the letter of credit and not in the underlying agreement between your company and the customer.

Example Assume that Trade Creditor sells Customer pig iron based on a supply contract. The Contract provides that, if the Customer files bankruptcy, it shall be a default under the supply contract. The letter of credit provides that, if the Customer defaults under the supply contract, Trade Creditor is entitled to draw on the letter of credit. When Customer files bankruptcy, the Trade Creditor will not be able to draw on the letter of credit.

Why not? Contracts that provide that, if a debtor files bankruptcy, it is a default under the contract are unenforceable as long the debtor is in bankruptcy. Therefore, in the example above, Customer's bankruptcy filing does not result in a default under the supply contract. Therefore, based on the terms of the letter of credit, Trade Creditor is not entitled to draw because Customer is not in default.

What is the solution? *Insert a provision in the letter of credit that Customer's filing bankruptcy shall entitle Trade Creditor to draw on the letter of credit.*

Remove Any Conditions From the Letter of Credit

It is typical in the commercial setting to require a party to give notice to another party – or even give the other party the right to cure – before taking adverse action. In the letter of credit context, if Customer is in bankruptcy, such requirements may render a letter of credit virtually worthless.

Example Trade Creditor obtains a letter of credit from Issuing Bank in connection with its sale of scrap metal to Customer. The letter of credit provides that Trade Creditor is entitled to draw on the letter of credit if Customer files bankruptcy. However, the letter of credit requires Trade Creditor to give Customer five (5) business days notice before being entitled to draw on the letter of credit. When Customer files bankruptcy, Trade Creditor will not be able to draw on the letter of credit unless it gets bankruptcy court approval.

Why not? The automatic stay associated with Customer's bankruptcy case will prevent Trade Creditor from sending a notice to Customer without bankruptcy court approval.

What is the solution? *Insist that your company should not be required to give any notice to, obtain consent from, or give Customer the right to cure as a condition to drawing on the letter of credit. This will help ensure that your company's right to draw on the letter of credit does not get entangled in Customer's bankruptcy.*

Obtain the Letter of Credit Before Extending Credit

If Trade Creditor obtains the letter of credit after it has already extended credit to Customer and Customer gives Issuing Bank a security interest in assets to secure its reimbursement obligation, Trade Creditor may have preference exposure if it draws on the letter of credit.

Example Trade Creditor obtains a letter of credit from Issuing Bank on account of the credit Trade Creditor has already extended to Customer. Customer enters into an agreement whereby it is obligated to reimburse Issuing Bank if Trade Creditor draws on the letter of credit. Issuing Bank obtains a perfected security interest in substantially all of Customer's assets to secure Customer's reimbursement obligation. When Customer fails to pay as agreed, Trade Creditor draws on the letter of credit. Within less than ninety (90) days of all of the foregoing, Customer files bankruptcy. Trade Creditor has preference exposure for the money it drew on the letter of credit.

Why? Although Trade Creditor did not receive a direct transfer from Customer (after all the draw came from Issuing Bank and not from Customer), some courts have held that it has received an "indirect" preference. As such, Trade Creditor has preference exposure.

What is the Solution? If Trade Creditor obtained the letter of credit as set forth above, but obtained it before it extended any credit to Customer, it would probably not have any preference exposure. The reason is that it could probably take advantage of the contemporaneous exchange for new value defense to a preference.

Discourage Customer From Granting Issuing Bank a Security Interest

There is another solution for Trade Creditor in the situation set forth on the previous slide. Trade Creditor should try to discourage Customer from granting Issuing Bank a security interest in Customer's assets to secure Customer's reimbursement obligation. If Issuing Bank does not obtain a security interest, then a bankruptcy court is probably not going to find that there has been an "indirect transfer" to Trade Creditor. The problem with this suggestion is that it may be very difficult for Customer, if it is financially distressed, to find a bank willing to issue a letter of credit without obtaining security for Customer's reimbursement obligation.

Require Issuing Bank to Pay with Its Own Funds

One purpose of a letter of credit is for Trade Creditor to remove itself from the bankruptcy or financial insolvency risks of Customer. To that end, the letter of credit should require Issuing Bank to pay Trade Creditor with its own funds as opposed to Customer's funds. By doing so, it reduces the chances that Customer's bankruptcy could adversely affect Trade Creditor.

Robert M.D. Mercer is a partner in the Atlanta office of the law firm of Powell Goldstein, LLP, where he practices in the Bankruptcy & Financial Restructuring Group. Mr. Mercer has represented unsecured creditors' committees in chapter 11 bankruptcies and trade creditors around the country both inside and outside of bankruptcy. Mr. Mercer regularly speaks and writes on issues of concern to credit professionals. Mr. Mercer has been selected as a Georgia Rising Star in Bankruptcy Law by *Law & Politics* and the *Atlanta Magazine*.

Structuring Letters of Credit That Won't Leave You Stranded in a Customer Bankruptcy

NACM's 2008 Audio Teleconference Series

Monday, April 21, 2008

Robert M.D. Mercer, Esq.
Powell Goldstein, LLP
404.572.6976
rmercer@pogolaw.com