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INDEPENDENT ASSURANCE: STANDBY LETTERS OF CREDIT AS COLLATERAL IN COMMERCIAL TRANSACTIONS

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The letter of credit has evolved from being a tool to facilitate international commercial transactions involving the sale of goods to a preferred form of collateral in a range of commercial transactions. While historically a commercial letter of credit was used to assure the seller of goods of the buyer's payment, the standby letter of credit has emerged as a means of guaranteeing or securing a monetary obligation owed by the issuing bank's customer to a third party. The popularity of using standby letters of credit as a type of guaranty in commercial transactions is mostly due to a unique feature of the letter of credit known as the "independence principle," which holds that the obligation of the issuing bank to honor a drawing request under a letter of credit is independent from the transaction that the letter of credit supports. Courts and legislators have worked to preserve the independence principle by establishing that letters of credit in commercial transactions constitute a security interest or claim against the property of the issuer and not of the debtor.

The Independence Principle

Letters of credit are often preferred forms of collateral in commercial transactions due to the independence principle that undergirds all uses of such letters of credit across jurisdictions. The courts have recognized three separate contractual relationships created by a letter of credit transaction. First, underlying the letter of credit transaction is the contract between the issuing bank's customer and the beneficiary of the letter of credit, which consists of the business agreement between these parties. Second, there is a contractual arrangement between the issuing bank and its customer whereby the bank agrees to issue the letter of credit and the customer agrees to repay the bank for the amounts paid under the letter of credit. Third, there is the contractual relationship between the bank and the beneficiary of the letter of credit created by the letter of credit itself, whereby the bank agrees to honor the beneficiary's drafts or demands for payment provided they conform to the terms of the letter of credit.[1] As a leading letter of credit case in California, *San Diego Gas & Electric Co. v.*

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Bank Leumi, has observed, however, although the relationship between the issuer and beneficiary of a letter of credit is often loosely described as "contractual," this characterization is inaccurate.[2] Rather, as the authors of a noted treatise on the Uniform Commercial Code, White and Summers, state, while some characterize the letter of credit as "a contract between the beneficiary and the issuer, . . . it is better to call it an 'undertaking' and so avoid the implication that contract principles might apply to it."[3]

Regardless of the nature of the undertaking, the independence principle embodies the notion that each of the three above "contractual" relationships created by a letter of credit are separate and independent from each other. Section 5114, subdivision (1) of the California Uniform Commercial Code, which governs traditional letters of credit and standby letters of credit, provides that "[a]n issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract between the customer and the beneficiary." Subdivision (1) reflects the concept that the letter of credit is independent from the underlying sales contract.[4] Absent fraud, the issuer must pay upon proper presentment regardless of any defenses the applicant for the letter of credit may have against the beneficiary arising from the underlying transaction.[5] The issuer of a letter of credit is never entitled to defend against payment based on extraneous defenses which might have been available to the primary obligor.[6]

The independence principle highlights two important policy considerations when using standby letters of credit in commercial transactions. "First, the issuing bank can assume no liability for the performance of the underlying contract because it has no control over making the underlying contract or over selection of the beneficiary. Second, the letter of credit would lose its commercial vitality if, before honoring drafts, the issuing bank were obliged to look beyond the terms of the letter of credit to the underlying contractual controversy between its customer and the beneficiary."[7] The crucial importance of separating the issuer's obligation from that of the customer is emphasized in the language used by courts in other jurisdictions that have reinforced the importance of the independence principle to the issuing bank as well as the customer and the beneficiary. Thus, as the Connecticut Supreme Court in *New York Life Ins. Co. v. Hartford National Bank & Trust Co.*, 173 Conn. 492, 378 A.2d 562, 566 (1977) stated, "[o]ne of the expected advantages and essential purposes of a letter of credit is that the beneficiary will be able to rely on assured, prompt pay-

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ment from a solvent party; necessarily, a part of this expectation of ready payment is that there will be a minimum of litigation and judicial interference, and this is one of the reasons for the value of the letter of credit device in financial transactions." Similarly, in *Ward Petroleum Corp. v. Federal Deposit Ins. Corp.*, 903 F.2d 1297, 1299 (10th Cir. 1990), the Tenth Circuit Court of Appeals stated that "[t]he independence of the letter of credit from the underlying commercial transaction facilitates payment under the credit upon a mere facial examination of documents; it thus makes the letter of credit a unique commercial device which assures prompt payment." More succinctly, the court in *Eakin v. Continental Illinois Nat. Bank and Trust Co. of Chicago*, 875 F.2d 114, 116 (7th Cir. 1989) put it this way: "Letters of credit are designed to avoid complex disputes about how much the beneficiaries 'really' owe. The promise and premise are 'pay now, argue later.' "

In *Voest-Alpine International Corp. v. Chase Manhattan Bank, N.A.*,[8] the Second Circuit Court of Appeals reinforced that the reliability of the letter of credit is specifically due to the independence principle, stating:

> "Since the great utility of letters of credit arises from the independent obligation of the issuing bank, attempts to avoid payment—premised on extrinsic considerations—contrary to the instrument's formal documentary nature—tend to compromise their chief virtue of predictable reliability as a payment mechanism . . . viewed in this light it becomes clear that the doctrine of strict compliance with the terms of the letter of credit functions to protect the bank which carries the obligation to pay the beneficiary. Adherence to this rule ensures that the banks, dealing only in documents, will be able to act quickly, enhancing the letter of credit's fluidity. Literal compliance with the credit therefore is also essential so as not to impose an obligation upon the bank that it did not undertake and so as not to jeopardize the bank's right to indemnity from its customer."[9]

Preserving the Independence Principle in the Use of Letters of Credit as "Collateral"

Courts and legislators have consistently used the independence principle to find that a standby letter of credit constitutes a security interest in the property of the issuer rather than property of the debtor. This fundamental aspect of the letter of credit relationship has been relied upon most recently in a California case involving the use of a letter of credit as a form of collateral in a commercial lease transaction. In *RREEF America REIT II Corp. YYYY v. Samsara Inc.*,[10] the issue was whether the letter of credit constituted "property of the debtor" for purposes of the California attachment statute, which permits attachment of

unpledged property of a debtor only to the extent the debtor's obligation is not already secured by other "property of the debtor."[11] The defendant tenant in the case, Samsara Inc. had entered into a lease with RREEF America REIT II Corp. YYYY to rent office space in San Francisco. The lease required Samsara to provide Rreef with a letter of credit that was to serve as collateral for full performance by Samsara of all of its obligations under the lease and for all losses and damages Rreef might suffer as a result of Samsara's failure to comply with the terms of the lease. Continuing disputes over the environmental condition of the premises and remediation efforts by Rreef resulted in Rreef filing a complaint for unlawful detainer and recovery of the premises, recovery of all unpaid rent, and damages for each day Samsara had continued possession until the date of judgment. The amount claimed by Rreef, approximately $2.8 million, was far less than the $11 million amount of the letter of credit that it held to secure the tenant's obligations under the lease. Nevertheless, Rreef sought and obtained a prejudgment right to attach order allowing it to attach other unsecured assets of Samsara pending trial of the underlying causes of action.[12]

Samsara made several arguments in opposition to Rreef's request for an attachment order, one of which was that Rreef was not entitled to attachment because its claim was fully secured by the letter of credit. Samsara's argument was based on Civ. Proc. Code, § 483.015, subd. (b)(4), which provides that the amount an applicant seeks to secure by attachment shall be reduced by the value of any security interest in the property of the defendant held by the plaintiff to secure the defendant's indebtedness claimed by the plaintiff, together with the amount by which the value of the security interest has decreased due to the act of the plaintiff or a prior holder of the security interest. Samsara claimed that the amount to be secured by the attachment should be reduced by the amount remaining on the letter of credit.[13] Separately, Samsara argued that Rreef's interest in the letter of credit was a security interest within the meaning of the § 483.015, subd. (b)(4) because the parties agreed that the letter of credit would be used as collateral for Samsara's performance under the agreement. Rreef countered that the interest in the letter of credit was not a security interest in the property of Samsara since it was the issuer of the letter of credit (i.e., Samsara's bank), rather than Samsara itself that was obligated to make payment to the beneficiary (i.e., Rreef). In other words, the letter of credit was not property of the debtor and could not be used to reduce the otherwise-unsecured liability of the debtor for purposes of the attachment statute.

The trial court sided with Rreef and granted Rreef's request for a right to at-

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tach order, clarifying that under § 483.015, subd. (b)(4), the amount of the plaintiff's claim to be secured by attachment can only be reduced by the value of the plaintiff's "security interest" in the "property of the defendant . . ." and that "security interest" as used in the § 483.015, subd. (b)(4) means a "security interest" as defined in § 1201 of the Commercial Code.[14] Samsara appealed.[15]

On appeal, the court initially considered whether a beneficiary's interest in a letter of credit constitutes a security interest in the property of the party who purchased the letter of credit. The court noted that there was no previous case law specifically addressing whether a beneficiary's interest in a letter of credit constitutes a security interest under the California Commercial Code, and if it is a security interest, that it is a security interest in the customer's property.[16] The court concluded that because the parties agreed to use a letter of credit as collateral for Samsara's performance under the lease, Samsara's performance was secured by the issuing bank's obligation to pay on the letter of credit and not by Samsara's property. As such, the court of appeal held that where a letter of credit is used as collateral, it is the issuer's property that guarantees payment under the parties' agreement, not the debtor's.[17] As a result of this conclusion, the court of appeal in *Rreef America* did not have to decide whether a beneficiary's interest in a letter of credit also constitutes a "security interest" within the meaning of Division 9 of the California Commercial Code, nor whether it fell under the other case law governing security deposits in commercial leases. For purposes of the attachment statute, it was sufficient that the tenant's obligations were not secured by the tenant's property but rather by the issuer's—a result that was directly attributable to enforcement of the independence principle.

The *Rreef America* court also looked to the California Supreme Court's decision in *Western Security Bank, N.A. v. Superior Court*,[18] which had balanced California's anti-deficiency statutes that circumscribe enforcement of obligations secured by interests in real property with the independence principle.[19] The *Western Security* case "concerns the extent to which two disparate bodies of law interact when standby letters of credit are used as additional support for loan obligations secured by real property."[20] The particular anti-deficiency statute analyzed in *Western Security* is Civ. Proc. Code § 580d, which "precludes a judgment for any loan balance left unpaid after the lender's nonjudicial foreclosure under a power of sale."[21]

In *Western Security*, the Beverly Hills Business Bank (formerly known as Beverly Hills Savings and Loan) had loaned an amount to a limited partnership,

Vista Place Associates, to finance the purchase of real property improved with a shopping center. The loan was secured by a deed of trust as well as a letter of credit. After Vista defaulted on the loan, Beverly and Vista agreed to a loan modification so that Vista could continue operating in the shopping center and repay the debt. As part of this transaction, each of the three Vista partners obtained unconditional, irrevocable standby letters of credit issued by Western Security Bank, N.A., in favor of the Beverly, which were delivered to Beverly as additional collateral security for the loan. Under the modification agreement, Beverly was entitled to draw on the letters of credit if Vista defaulted or failed to pay the loan in full at maturity. Each partner in turn agreed to reimburse Western if it ever had to honor the letters and each gave Western a promissory note embodying this obligation.

Beverly later declared Vista in default on the modified loan and foreclosed on Vista's real property, with the sale leaving an unpaid deficiency. Rather than claim the deficiency directly from Vista or Vista's partners, Beverly delivered documentary drafts to Western demanding payment under the letters of credit. After Vista's attorneys delivered a notice to Western asserting that Code of Civil Procedure § 580d barred Western from seeking reimbursement from the Vista partners for any payment on the letters of credit, Western declined to honor the drafts. Instead, Western filed a declaratory relief action against Beverly, as well as Vista and Vista's partners. The trial court rejected the application of § 580d and found that the Bank was entitled to recover the full loan amount from Western, plus interest, and that Western could seek reimbursement from the Vista partners severally, with each Vista partner obligated to reimburse Western pursuant to its promissory note. This judgement was appealed by Vista and its partners.

The court of appeal in *Western Security* "perceived a conflict between the public policies behind § 580d and the independence principle," when a lender attempts to draw on a standby letter of credit of which it was the beneficiary after nonjudicial foreclosure of the real property security for its loan left a deficiency.[22] Because ordinarily the issuer's payment on a letter of credit would require the borrower to reimburse the issuer, the court of appeal "considered that this result indirectly imposed on the borrower the equivalent of a prohibited deficiency judgment" under § 580d—a result that the court of appeal found would justify the issuing bank's refusal to honor an otherwise compliant draft under a letter of credit.[23] Such a use of a standby letter of credit to indirectly recover a deficiency in light of the debtor's obligation to reimburse the issuer after

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a draw on the letter of credit by the beneficiary would constitute a "defect not apparent on the face the documents" within the meaning of Commercial Code § 5114(2)(b), and therefore "such permissive dishonor does no offence to the independence principle."[24] Accordingly, the court of appeal reversed the trial court and upheld Western's refusal to honor a draft on the letter of credit, despite the independence principle.

The continued history of the *Western Security Bank* case *after* this initial decision by the court of appeal is an example of a legislative reaffirmation of the independence principle in response to an arguable judicial infringement on that principle. The California Supreme Court granted review of the court of appeal's decision, but before the case was heard by the Supreme Court, the California Legislature passed an amendment to the anti-deficiency statutes "specifically meant to abrogate the court of appeal's holding."[25] Specifically, the Legislature added a new § 580.5 to the California Code of Civil Procedure, which as amended now explicitly *excludes* letters of credit from the purview of the anti-deficiency statutes.[26] The Legislature explained that its intent was to "confirm the independent nature of the letter of credit engagement . . ." and to "confirm the expectation of the parties to a contract that underlies a letter of credit without regard to the order in which the beneficiary may resort to either."[27] Thus, the Legislature used the independence principle to clarify that the existing law viewed a letter of credit as an independent obligation of the issuing bank rather than as a form of guaranty or a surety obligation or an "end run" around the limitations of the anti-deficiency law against recovery of a deficiency from the principal debtor.[28]

Following the Legislature's action, the Supreme Court remanded the case to the court of appeal to reconsider the cause in light of the amendment to the anti-deficiency statutes. The court of appeal then filed its second opinion, reiterating its prior reasoning and conclusions and again reversing the trial court. This decision was promptly reversed by the Supreme Court, which found unequivocally that a letter of credit was not a form of guaranty in part because suretyship involves no counterpart to the independence principle essential to letters of credit.[29] Rather, the Supreme Court effectively held that the issuer's obligation under a letter of credit is independent from the customer's and held that under a letter of credit used as collateral for a debt, it is the issuer's property, rather than the customer's, that secures the debt. This conclusion in turn was relied upon by the court of appeal in *Rreef America*, which stated:

> *Western Security* is instructive because it found that a letter of credit is "a form of security for assuring another's performance" and it indicates that the issuer's obligation to pay the beneficiary—and not the customer's property—serves as security where, as here, the customer and the beneficiary intended the letter of credit to act as collateral. That the customer's property does not serve as security in such a situation is dispositive of the question whether Rreef has a security interest in the property of Samsara.[30]

The Independence Principle and Letters of Credit in Bankruptcy Cases

One of the salutary effects of the independence principle is to separate the customer's obligation to pay the beneficiary as well as its obligation to reimburse the issuer from the issuer's obligation to honor the beneficiary's demands. In effect, it removes the beneficiary's need to pursue remedies against the customer in default, and shifts the liability to the issuer, regardless of whether the issuer will then be able to recoup the amount of its payments to the beneficiary from the customer. This distinct advantage of using standby letters of credit as collateral emerges when a customer in a commercial transaction files for bankruptcy or is placed in a receivership, and was aptly summarized in the following excerpt from the White & Summers treatise:

> If . . . the customer goes into bankruptcy after the letter has been issued, but before it has been drawn upon, the issuer must pay despite the fact that the customer will not be able to pay the issuer. The same would be true if the customer had repudiated the contract of reimbursement. Since these are the very risks (customer's insolvency or unwillingness to pay) which the beneficiary sought to avoid by demanding the issuance of the letter of credit, it should not be surprising that the issuer cannot assert them as defenses against the beneficiary.[31]

The general effect of a letter of credit, therefore, is to allow the creditor to seek payment of the bankrupt's debt even after the bankruptcy filing, at a time when the Bankruptcy Code otherwise would limit the creditor to filing a claim and seeking relief from stay to pursue remedies against the debtor or the debtor's property held as collateral for the debt. Courts have usually found, applying the independence principle, that the letter of credit is not property of the bankruptcy estate and therefore an automatic stay does not prevent a beneficiary from presenting and drawing on the letter of credit after the customer files for bankruptcy.[32] Similarly, a creditor who holds a letter of credit given as security before the 90-day "reachback rule" for preferential transfers also can still demand and receive payment from the issuing bank without, as a general rule, being deemed to have received a preference that is recoverable by the debtor's trustee

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in bankruptcy.[33] In both contexts, the reason the debtor's bankruptcy does not prevent recovery under the letter of credit is the independence principle.

A Fifth Circuit Court of Appeals decision, *In Re Stonebridge Technologies, Inc*.[34] illustrates the operation of the independence principle in bankruptcy cases—that is, the beneficiary holding a letter of credit can draw on the letter of credit in strict conformity with the tems of the letter of credit documentation requirements even after bankruptcy of the customer, and the issuer is obligated to honor the draw request as neither the letter of creditor the funds drawn under it are property of the debtor. *In re Stonebridge* concerned an action brought by the trustee of a liquidating trust established under the confirmed Chapter 11 plan of Stonebridge Technologies, Inc., as tenant, against EOP-Colonnade of Dallas Limited Partnership, as landlord, in connection with EOP's draw on a letter of credit that was provided as security for Stonebridge's obligations under the lease. In the bankruptcy court, the trustee asserted that as a result of the bankruptcy filing, EOP was subject to the limitations of 11 U.S.C.A. § 502(b)(6), which caps the amounts recoverable by a landlord from a commercial tenant's estate in bankruptcy—which, the trustee asserted, meant that by drawing prematurely in a greater amount on the letter of credit, EOP had breached the lease and made negligent misrepresentations to the issuing bank in its draw request, justifying return of the amounts drawn to the bankrupt's estate.

The bankruptcy court agreed that EOP did breach the lease and made negligent misrepresentations by prematurely drawing on the letter of credit and retaining an amount in excess of what it was entitled to retain, and the district court affirmed the bankruptcy court's decision,[35] but the Fifth Circuit Court of Appeals reversed, based on the independence principle, holding that the trustee could not recover the sums drawn by EOP under the circumstances. In doing so, the court noted, "It is well established in this circuit that letters of credit and the proceeds therefrom are not the property of the debtor's bankruptcy estate."[36] The court of appeals went on to say that "[i]nsofar as letters of credit embody obligations between the issuer and the beneficiary, *such contractual rights are entirely separate from the debtor's estate*."[37] The cap of 11 U.S.C.A. § 502(b)(6) only applies to the landlord's right to recover from the bankruptcy estate, and does not apply to the independent claim by the landlord against the issuer of a letter of credit held as collateral.[38] As a result, based on the tenant's monetary default under the lease and EOP's right to accelerate rent and draw on the letter

of credit regardless of the bankruptcy, there was nothing wrong with EOP's call under the letter of credit; it was consistent with the terms of the letter of credit despite the intervening bankruptcy of the tenant who had procured the letter of credit.[39]

Care must be exercised in relying on the Fifth Circuit's decision in *Stonebridge* for cases arising in the Ninth Circuit, where the Bankruptcy Appellate Panel has adopted a slightly different analysis. In *In re Mayan Networks Corp.*,[40] the BAP held that to the extent a landlord's draw on a letter of credit exceeds the cap on liability in § 501(b)(6), the excess is recoverable as an asset of the bankrupt estate. The *Mayan Networks* decision treats the independence principle in this context as a "red herring" due to the operation of bankruptcy law in this area, although the concurring opinion in that case would have reached the same result as the majority even when applying the independence principle in the particular case before it. In *Stonebridge,* the Fifth Circuit distinguished *Mayan Networks* on a different basis, but *Mayan Networks* is arguably inconsistent with the *Stonebridge* rationale on this issue. That said, a post-*Stonebridge* Ninth Circuit decision reiterated the importance of the tripartite independence principle and made it clear that while the trustee in bankruptcy may have rights to recover excess amounts from the beneficiary who draws on a letter of credit held as security, that does not mean the letter of credit draw, as such, should be enjoined or limited. In that case (*In re Onecast Media, Inc.*),[41] the Ninth Circuit Court of Appeals stated,

> Letter of credit transactions involve three relationships: that of the bank to its customer who purchases the letter of credit; that of the bank to the beneficiary to whom it makes a promise to pay; and finally, that between the customer and the beneficiary. [citation omitted]. Under the so-called principle of independence, each of those three transactions must be treated separately. [citation omitted]. This case does not involve the first two relationships. There is no issue concerning the bank's performance under the letter of credit. Indeed, the Landlord, the beneficiary, has drawn down the full amount of the letter of credit. What is at issue here is simply the controversy between the Landlord and the Trustee over how much of the funds held by the Landlord it is entitled to retain. Following One-Cast's default under the lease, the Landlord drew down the entire letter of credit as the security deposit. The Trustee now seeks to recover so much of the security deposit as exceeded the Landlord's damages. The Trustee's interest in those funds is property of the estate, 11 U.S.C. § 541(a)(1) (2000), and thus within the bankruptcy court's jurisdiction. *In re Kaiser Group Int'l Inc.,* 399 F.3d 558, 566 (3d Cir. 2005); *In re Graham Square, Inc.,* 126 F.3d 823, 828 (6th Cir. 1997) ("It is one thing to attempt to prevent the distribution of the proceeds of a letter of

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credit, an attempt the doctrine of independence is designed to prevent; but it is quite another to bring an action on the underlying contract that created the letter of credit."); *In re Papio Keno Club, Inc.,* 247 B.R. 453, 460 (B.A.P. 8th Cir. 2000) ("The fact that Debtor seeks the return of funds that are proceeds of a letter of credit does not negate the breach of contract claim on the underlying obligation").[42]

Bankruptcy cases involving the trustee's powers of avoidance of preferences and fraudulent conveyances are myriad, and the outcomes of such cases may not always appear consistent when considering letters of credit drawn upon by creditors of the estate. For example, one of the cases cited by *In re Stonebridge*, known as *In re Compton*,[43] involved an effort by the trustee in bankruptcy of a defaulting purchaser, the *customer* under a standby letter of credit, to recover amounts paid *to the beneficiary* by the *issuer* of the letter of credit. Blue Quail Energy, Inc. had delivered a shipment of oil to Compton Corporation, and after Compton defaulted on the payment, Compton arranged for its bank, MBank-Abilene, to issue an irrevocable standby letter of credit in Blue Quail's favor, one of several letters of credit previously issued under the same reimbursement agreement, which was secured by a UCC security interest in Compton's assets in favor of MBank-Abeline. This additional letter of credit issued by MBank-Abeline was treated as new value for the increased security interest it obtained in Compton's collateral, and therefore, under bankruptcy law, was not a preferential transfer. However, the giving of a letter of credit by Compton to Blue Quail to secure an antecedent debt (the unpaid purchase price for the oil) was a preferential transfer.

The day after MBank-Abilene issued the letter of credit, several of Compton's creditors filed an involuntary bankruptcy petition against Compton. In the bankruptcy proceeding, MBank-Abilene's aggregate secured claims, including the letter of credit, were paid in full from the liquidation of Compton's assets, which served as the bank's collateral. Compton's trustee in bankruptcy, William Kellogg, then filed a complaint in bankruptcy court against Blue Quail asserting that Blue Quail had received a preferential transfer under 11 U.S.C. § 547 through the letter of credit[44]. Because collateral that has been pledged by a debtor as security for a letter of credit is the property of the debtor's estate,[45] Kellogg claimed that the direct transfer to MBank-Abeline of the increased security interest covering the additional claim against Compton's assets constituted an indirect transfer to Blue Quail occurring one day prior to the filing of the involuntary bankruptcy petition and was voidable as a preference under 11 U.S.C. § 547.[46]

The Fifth Circuit Court agreed, holding that "a creditor cannot secure a payment of an unsecured debt through a letter of credit transaction when it could not do so through any other type of transaction" and that it would not allow an unsecured creditor to avoid a preference attack by utilizing a letter of credit to secure the payment of an antecedent debt.[47] However, the result was not to allow the issuer of the letter of credit (MBank-Abilene) to dishonor the draw request by Blue Quail, it was rather to deny the creditor, Blue Quail, the right to retain funds drawn on the letter of credit in the first place. In other words, Blue Quail had received an "indirect preference" and was liable to the trustee for the amount of the letter of credit drawn by Blue Quail, but Blue Quail had no claim against MBank-Abilene for the funds recovered by the bank from its own collateral for the letter of credit, and MBank-Abilene was not required to disgorge the additional collateral it had effectively acquired at the time it arranged the additional letter of credit.

The decision in *In re Compton* is only one of many cases involving the application of preference law to letters of credit in bankruptcy, and it was a very narrow holding. But the court of appeals was careful to note that its holding preserved the letter of credit's sanctity and the underlying independence doctrine. As the court stated:

> The precise holding in this case needs to be emphasized. We do not hold that payment under a letter of credit, or even a letter of credit itself, constitute preferential transfers under 11 U.S.C. § 547(b) or property of a debtor under 11 U.S.C. § 541. The holding of this case fully allows the letter of credit to function. We preserve its sanctity and the underlying independence doctrine. We do not, however, allow an unsecured creditor to avoid a preference attack by utilizing a letter of credit to secure payment of an antecedent debt. Otherwise the unsecured creditor would receive an indirect preferential transfer from the granting of the security for the letter of credit to the extent of the value of that security. Our holding does not affect the strength of or the proper use of letters of credit. When a letter of credit is issued contemporaneously with a new extension of credit, the creditor beneficiary will not be subject to a preferential attack under the direct/indirect doctrine elaborated in this case because the creditor will have given new value in exchange for the indirect benefit of the secured letter of credit. Only when a creditor receives a secured letter of credit to cover an unsecured antecedent debt will it be subject to a preferential attack under 11 U.S.C. § 547(b).[48]

Although there are exceptions, most courts that have considered whether a post-petition draw on a prepetition letter of credit issued prior to the 90-day "reachback" period is a preferential transfer have concluded it was not, based

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specifically on the independence principle.[49] A typical case is *In re ITXS, Inc.*, where the Bankruptcy Court held that a landlord's draw on a letter of credit issued on behalf of the tenant was not an avoidable preference, because it was the issuing bank's property, rather than debtor's property, that was transferred, and the date collateral had been pledged by the debtor tenant to the issuing bank to secure its reimbursement obligation was well before the beginning of the 90-day preference period.[50]

The Independence Principle and Letters of Credit in Receivership Cases

Courts in receivership cases have similarly found that the independence principle calls for letters of credit to be treated as the issuer's property. In *Federal Deposit Ins. Corp. v. United States Trust Co.*,[51] the Federal Deposit Insurance Company ("FDIC") was the receiver of a failed bank that had leased equipment, using a letter of credit to secure its performance under the lease. After the bank was placed in receivership, the lessor of the equipment presented the letter of credit to the issuing bank, seeking to draw on the letter of credit. Shortly thereafter, the FDIC disaffirmed the equipment lease, the letter of credit, and the pledge agreement between the failed bank and the issuing bank. The FDIC also filed an action seeking to enjoin the lessor from receiving payment under the letter of credit.[52] While *Federal Deposit* was decided in a receivership context, the court drew upon letters of credit in bankruptcy proceedings in making its decision. The court held that "If . . . the customer goes into bankruptcy after the letter has been issued, but before it has been drawn upon, the issuer must pay despite the fact that the customer will not be able to pay the issuer. The same would be true if the customer had repudiated the contract of reimbursement."[53] In *Federal Deposit,* the court found that the lessor was not seeking to enforce its rights under the lease, but was seeking to enforce its rights against the issuing bank under the letter of credit, thus reaffirming the independence principle.

The court in *California Bank & Trust v. Piedmont Operating Partnership, L.P.*, 218 Cal. App. 4th 1322, 1335, 161 Cal. Rptr. 3d 167 (4th Dist. 2013) examined whether a lessor has the right to draw down a letter of credit securing the lessor's right to collect future rent under a lease to a failed bank that is disaffirmed by the FDIC. In *California Bank & Trust*, Piedmont Operating Partnership, L.P. leased office space to Alliance Bank, and Alliance Bank provided Piedmont with a $500,000 letter of credit issued by Union Bank of California,

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N.A. Alliance Bank put $500,000 on deposit at Union Bank as collateral for the letter of credit. The Commissioner of Financial Institutions closed Alliance Bank and appointed the FDIC as receiver. Pursuant to a purchase and asset assumption agreement, the FDIC sold the assets of Alliance Bank to California Bank & Trust, including the $500,000 deposit at Union Bank. The FDIC notified Union Bank that it was disaffirming the agreement between Union Bank and Alliance Bank concerning the letter of credit pursuant to Title 12 United States Code Section 1821(e). Piedmont filed a claim for future rent for the one-year period following the lease disaffirmance and presented a $500,000 site draft to Union Bank to draw down the letter of credit. Union Bank paid the proceeds of the letter of credit to Piedmont and debited California Bank's $500,000 account accordingly. California Bank later commenced litigation against Piedmont, alleging that Piedmont did not have the right to draw upon the letter of credit after the FDIC had disaffirmed the lease. The trial court entered a judgment in favor of Piedmont.[54]

On appeal, the court examined whether the Piedmont was entitled to keep the $500,000 that it had seized. The court found that Piedmont had no right to the $500,000 deposit, stating that "[t]o permit a landlord to effectively seize the collateral underlying a letter of credit after the FDIC has disaffirmed the lease and transferred the collateral to a successor bank would hamstring the FDIC in its efforts to wind up the affairs of a failed bank and promote stability in the banking system."[55] Thus, the obligation of the issuer to honor a compliant draw request was not in question, and the independence principle was preserved—the court instead found the liability of the beneficiary to the customer for an improper draw under their separate, independent agreement to which the issuer was not a party. Piedmont had no claim against California Bank, which had not assumed the lease and had no claim for future rent against the FDIC as receiver.

Limitations on Standby Letters of Credit in Consumer Transactions

While a standby letter of credit has undeniable advantages as a form of collateral, it is important to note that there are some limitations to its uses in consumer transactions. California Code of Civil Procedure § 580.7, which was enacted at the same time as § 580.5, provides that a letter of credit is not enforceable by any party in a loan transaction where (1) the customer is a natural person, (2) the letter of credit is issued to the beneficiary to avoid a default of the existing loan, (3) the existing loan is secured by a purchase money deed of trust or purchase money mortgage on real property containing one to four resi-

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dential units (at least one of which is owned and occupied, or was intended at the time the existing loan was made to be occupied, by the customer). This section, by its terms, does not apply to other types of consumer loans or loans to individuals, including loans that are not purchase money or that are secured other than by owner-occupied residential real property. Further, § 5102, subd. (a)(9) of the California Commercial Code provides that the *issuer* can never be a consumer in an engagement for personal, family, or household purposes. The Commercial Code comments explain that this is to prevent the structure of a transaction with a letter of credit to deprive the consumer of protections or defenses against the creditor/beneficiary of the letter of credit: "In a consumer transaction, an individual cannot be an issuer where the person would otherwise be either the principal debtor or a guarantor." However, § 5102 does not directly preclude a consumer from being an "applicant" for a letter of credit outside the narrowly circumscribed real property secured context of § 580.7. The term "applicant," as defined in § 5102, subd. (a)(2), does not expressly exclude consumers in an engagement for personal, family, or household purposes. Therefore, where a letter of credit is furnished by a non-consumer issuer to support credit extended to a consumer debtor in a consumer transaction, the potential issue of whether the letter of credit can be used to circumvent consumer defenses would arise. A strict application of the independence principle would suggest that it could, but it remains to be seen whether the courts would agree with that determination.

Conclusion

Standby letters of credit have become an important form of collateral across the spectrum of commercial transactions due to the independence principle. The independence principle results in the view that the security or collateral provided by the letter of credit is the issuer's property rather than the customer's property, and the customer's underlying defenses to liability under its agreements with the beneficiary or with the issuer do not affect the beneficiary's right to draw on the letter of credit as its security. Courts and legislators have consistently reinforced the idea that the issuer's obligation to honor a draw request conforming to the facial terms of the letter of credit is independent of the underlying agreement between the creditor/beneficiary and the applicant/account party for whom letter of credit was issued. The result in commercial transactions is to provide the creditor with a relatively unfettered right to access the property of the issuer as collateral for the debt, while leaving the applicant to prove its own remedies directly with the beneficiary if the beneficiary has

wrongly drawn on the letter of credit or drawn more than ultimately is owed by the applicant on the underlying debt. These attributes make the standby letter of credit a preferred form of collateral in many situations, including commercial leasing transactions.

ENDNOTES:

[1]Eg., *In re Onecast Media, Inc.*, 439 F.3d 558, 564 (9th Cir. 2006); *Colorado Nat. Bank of Denver v. Board of County Com'rs of Routt County*, 634 P.2d 32, 36 (Colo. 1981).

[2]*San Diego Gas & Electric Co. v. Bank Leumi*, 42 Cal. App. 4th 928, 933, 50 Cal. Rptr. 2d 20 (4th Dist. 1996).

[3]3 White and Summers, Uniform Commercial Code (4th ed., 1995), § 26-2, p. 113.

[4]23B West's Ann. Cal. U. Com. Code, § 5114 (1964 ed.) p. 718.

[5]*San Diego Gas & Electric Co. v. Bank Leumi*, 42 Cal. App. 4th at 933.

[6]*Id*.

[7]*Ross Bicycles, Inc. v. Citibank, N.A.*, 161 Misc. 2d 351, 613 N.Y.S.2d 538, 540-541 (Sup 1994).

[8]*Voest-Alpine Intern. Corp. v. Chase Manhattan Bank, N.A.*, 707 F.2d 680, 682-683 (2d Cir. 1983).

[9]*Id*. at 683.

[10]*Rreef America Reit II Corp, YYYY v. Samsara Inc.*, 91 Cal. App. 5th 609, 308 Cal. Rptr. 3d 525 (1st Dist. 2023).

[11]Civ. Proc. Code, § 483.015, subd. (b)(4).

[12]*RREEF America REIT II Corp. YYYY v. Samsara Inc.*, 91 Cal. App. 5th at 614-615.

[13]*Id*. at 615-616.

[14]*Id*. at 616.

[15]*Id*.

[16]*Id*. at 619-620.

[17]*Id*. at 621-622.

[18]*Western Security Bank v. Superior Court*, 15 Cal. 4th 232, 62 Cal. Rptr. 2d 243, 933 P.2d 507 (1997).

[19]15 Cal. 4th at 236.

[20]*Id*.

[21]*Id*.

[22]*Id*. at 237.

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[23]*Id*.

[24]*Id*. at 241.

[25]*Id*. at 242.

[26]*Id*.

[27]Stats. 1994, ch. 611, § 5.

[28]*Western Security Bank, N.A. v. Superior Court*, 15 Cal. 4th at 250.

[29]*Id*.

[30]*RREEF America REIT II Corp. YYYY v. Samsara Inc*., 91 Cal. App. 5th at 619.

[31]White & Summers § 19.2, at 9.

[32]*In re Kmart Corp.*, 297 B.R. 525 (N.D. Ill. 2003); *In re Illinois-California Exp., Inc.*, 50 B.R. 232, 234-35 (Bankr. D. Colo. 1985).

[33]*In re ITXS, Inc.*, 318 B.R. 85 (Bankr. W.D. Pa. 2004).

[34]*In re Stonebridge Technologies, Inc.*, 430 F.3d 260 (5th Cir. 2005).

[35]*Id*., at 264.

[36]*Id*. at 269, citing *Matter of Compton Corp.*, 831 F.2d 586, 589 (5th Cir. 1987), on reh'g, 835 F.2d 584 (5th Cir. 1988).

[37]*Id*. (emphasis added).

[38]*Id*. at 270.

[39]*Id*. at 273-275.

[40]*In re Mayan Networks Corp.*, 306 B.R. 295, 298-299 (B.A.P. 9th Cir. 2004).

[41]*In re Onecast Media, Inc.*, 439 F.3d at 564.

[42]*Id.* at 564.

[43]*Matter of Compton Corp.*, 831 F.2d 586, 589 (5th Cir. 1987), on reh'g, 835 F.2d 584 (5th Cir. 1988).

[44]*Id*. at 589-590.

[45]*Id*. at 590.

[46]*Id*.

[47]*Id*. at 595.

[48]*Id*.

[49]Eg. *In re ITXS, Inc.*, 318 B.R. 85 (Bankr. W.D. Pa. 2004).

[50]*Id*.

[51]*F.D.I.C. v. U.S. Trust Co.*, 793 F. Supp. 368 (D. Mass. 1992).

[52]*Id*. at 369-370.

[53]*Id*. at 371.

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[54]*California Bank & Trust v. Piedmont Operating Partnership, L.P.*, 218 Cal. App. 4th 1322, 1335, 161 Cal. Rptr. 3d 167 (4th Dist. 2013).

[55]218 Cal. App. 4th at 1327.

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