SURETY TODAY PRESENTATION

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Our topic today is "Letters of Credit as the Surety's Collateral; The Expected and Unexpected." I will lead off with a discussion of the nature, purpose and structure of letters of credit; George will then follow and cover the unexpected occurs - the principal files a bankruptcy proceeding – what happens to the letters of credit. Then I will discuss what happens to the excess proceeds from the letter of credit. Finally, George will close out with a discussion of when the surety's receipt of a letter of credit is a preference under the bankruptcy law. We have a number of issues to cover and we'll get started right now with the nature, purpose and structure of letters of credit.

NATURE, PURPOSE AND STRUCTURE OF LETTERS OF CREDIT

Mike: A letter of credit is typically defined as an engagement by an issuer, usually a bank, made at the request of a customer for a fee to honor a beneficiary's draft or other demands for payment to the satisfaction of the conditions set forth in the letter of credit. Some of the basic nomenclature of letters of credit in the context of suretyship are that the "customer" or the "applicant" would be the principal under the bond; the "issuer" of the letter of credit would be the bank; the "beneficiary" under the letter of credit in the suretyship context would be, of course, the surety.

The primary purpose of a letter of credit is historically to facilitate commercial transactions by assuring the beneficiary of a letter of credit that they would get payment. Letters of credit were initially used as part of an international transaction when you weren't sure of the credit worthiness of the person you were dealing with and you would nominate the bank for the letter of credit and deal with the bank's credit as opposed to the person you are dealing with commercially. More recently, the use of the letter of credit has changed to what's known as a "standby letter of credit." The purpose of that form of letter of credit is really to act as a type of a guaranty. It serves to shift the risk of loss from the beneficiary under the letter of credit (the surety in our case) to the issuer or the bank, in the event that the principal can't pay.

A letter of credit is the product of three separate transactions, and it's helpful to look at it that way. It's helpful to describe it as the three legs of a tripod. The first transaction is that the principal request bonds from the surety and the surety demands as a part of its underwriting that a letter of credit be provided along with the indemnity agreement, etc. The second transaction is that the principal then requests the issuance of a letter of credit from the bank. The bank will issue a letter of credit after it obtains a fee for doing so and usually some collateral or security from the principal. The third transaction is the bank issuing the letter of credit to the surety with the surety as the beneficiary of the letter of credit. The linchpin or unique feature of a letter of credit that makes it a preferred form of collateral is something referred to as the "independence principle."

The independence principle holds that each of those three underlying transactions that I just mentioned are actually independent and separate from each other. The issuance of a letter of credit is completely separate and independent from the underlying transaction between the principal and the surety. The bank, the issuer of the letter of credit, is pledging its own credit and its own assets in the letter of credit to the beneficiary, regardless of what transpires in the underlying transaction between the principal and the surety. The bank is paying out its own money, regardless of whether the principal can reimburse it, or if any of the security or collateral that the bank got from the principal in exchange for issuing the letter of credit turns out to be worthless. If the bank can't recover from its security or collateral, that's too bad because the bank still has to pay on the letter of credit. The bank's obligation under the letter of credit transaction is independent and separate from the underlying transactions of the three.

Because of the independence principle and its universally accepted and enforced application to letters of credit, it is almost uniformly held that a letter of credit is ***not*** property of the bankruptcy estate, should the principal go into bankruptcy. This makes a letter of credit, of course, a unique and desirable form of collateral because any other type or form of collateral would likely become property of the estate in the event of a bankruptcy. Some other factors that make letters of credit the desired form of collateral include:

(1) Letters of credit are essentially a liquid form of collateral. In other words, you go to the bank that issued the letter of credit and make your demand, you get your money. That's about as liquid as you can be short of cash.
(2) Letters of credit have a fixed value, so there's no variation with the market. In 2006 real estate was worth a lot of money. In 2009, some of it wasn't worth much anymore. If you were holding real estate as collateral, you experienced a market fluctuation. Same thing with stocks, bonds, that kind of stuff. Letters of credits have fixed amounts and that's what you get.
(3) Letters of credit are easy to perfect a security interest in; you simply have to be the holder of the letter of credit and be the beneficiary of the letter of credit. If you are, then you "control" the letter of credit and you have perfected your security interest.
(4) There are no transaction fees or costs with letters of credit. There is an initial fee that is paid by the principal, but if you want to draw on the letter of credit, there is no fee to get paid. There is no fee or cost for instance like in real estate; if you want to sell property there would have to be fees and costs incurred with that. A letter of credit has none of that.

So, letters of credit have a lot of advantages as a form of collateral. Letters of credit are also unique under the law. They are considered to be a "commercial specialty" and are governed by their own unique terms. Letters of credit have similarities with guarantees, they have similarities with negotiable instruments and contracts, but they are not fully any of those things. They are separate entities. Letters of credit have their own rules. The Uniform Commercial Code ("UCC"), Article 5 governs letters of credits, assuming that that's been adopted in your jurisdiction. There are also generally accepted customs and practices that have been set forth in a document called the UCP 600. That's a document created by the International Chamber of

Commerce, which while not having the effect of law the UCP 600 is often incorporated into letters of credit and therefore, would have the force of contract and the UCP 600 can also be referred to as evidence for the custom and usage of letters of credit. Finally, letters of credit have, over the years, generated their own form of common law known as the "law merchant," which has established a lot of the underlying rules and principles relating to letters of credit, as well.

When one is dealing with a letter of credit, you need to be careful in reviewing the terms, in particular, two main issues. The first is the draw requirements on the letter of credit and the second is the termination or expiration provisions of the letter of credit. On the draw requirements, in order to draw on a letter of credit, the beneficiary must strictly conform to the requirements of the letter of credit. So, if you have to make your draw at a particular location during a particular time; if you have to have particular documents or make a specific representation, you have to be sure that you strictly comply with whatever the requirements are for making a draw on the letter of credit. You want to be careful that you don't have requirements in your letter of credit that cannot be met and be careful of about how that all is worded. The issuer's role under the letter of credit is simply ministerial. It is to pay a draw on demand and to make sure that the demand conforms, and if it does, then it has the obligation to pay. Of course, on the termination, you have to be careful about when that termination is and make sure that you either get the letter of credit renewed, if it's not on an automatic renewal, or you get replacement collateral.

UNEXPECTED OCCURS - THE PRINCIPAL FILES A BANKRUPTCY PROCEEDING

George: Before I discuss the unexpected issues with respect to the surety's taking of a letter of credit, I want to reemphasize a couple of points that Mike made. The independence principle is a critical concept. Under the letter of credit, the issuing bank is complying with its contractual obligations to the beneficiary of the letter of credit, which is the surety. Once the surety complies with the conditions under the letter of credit, the bank pays **its** money, the letter of credit proceeds to the surety, and I want to emphasize that the bank pays **its** money. The only contract between the issuing bank and the surety beneficiary is the letter of credit, and that's the only contract that is truly relevant. The other series of contracts that might be discussed, the principal/surety relationship, which could be an indemnity agreement or collateral agreement or the bonds, and the agreements between the principal and the issuing bank; they are irrelevant in determining the surety's rights to go ahead and draw on the letter of credit. That's the expected.

Now, the unexpected occurs when the surety's principal files a bankruptcy case and becomes a debtor. What happens to the surety's letter of credit? What happens to the surety's rights to draw on the letter of credit, and what happens to the surety's rights to use the letter of credit proceeds once it gets them? There are two main concepts that you have to keep in mind. Under section 541 of the Bankruptcy Code, it defines property of the debtor's estate, and property includes all of the principal's or debtor's legal or equitable interest in property as of the commencement of the bankruptcy case, wherever that property is located and by whomever that property is held. That property includes property that may even have contingent rights to it. The

bankruptcy courts will interpret what is property of the estate; they want to bring anything they can into the estate. The second main concept under the Bankruptcy Code is section 362, the automatic stay. An automatic stay arises as of the commencement of the bankruptcy case and prevents actions by all of the creditors to enforce their rights against property of the estate. This automatic stay includes any action that a surety may take against property of the debtor's estate in which the surety may have an interest, either a security interest of whatever, such as cash, deposit accounts, CD's, real and personal property. So, how do the concepts of property of the estate and the automatic stay affect the surety's collateral that is a letter of credit? You have to look at three questions:

(1) Is the letter of credit itself property of the debtor's estate? The answer is no. The letter of credit is a contract between the issuing bank and the surety beneficiary in which the principal or debtor has no property rights or interest.

(2) Are the proceeds of the letter of credit property of the debtor's estate? The cases say no, and the reason it is no is because it is the bank's money, not the principal debtor's property. I give you a caveat, however. If the principal debtor does provide its own collateral to secure the bank that has issued the letter of credit, the debtor may subsequently have rights to the letter of credit proceeds held by the surety and we will get to that issue later.

(3) Assuming that the surety can comply with any conditions in the letter of credit in order to draw on the letter of credit proceeds, does the automatic stay prevent the surety from drawing on the letter of credit. The answer is "no." The letter of credit proceeds are not property of the debtor's estate, and therefore the automatic stay does not apply.

Now practically, how should the surety proceed with respect to the letter of credit and drawing on the letter of credit during the debtor's bankruptcy case? First, unless there is some deadline or emergency, we have found that it is important for the surety before it draws on the letter of credit to at least discuss that draw with the debtor and its counsel prior to taking such action. They're going to appreciate it and it's going to smooth things over. Second, when should the surety draw on the letter of credit proceeds? Obviously, if the bank provides notice to the surety that it is not going to renew the letter of credit after the petition date at some point, then the surety should draw fully on the letter of credit before the expiration date of the letter of credit. As a result, when you have such a case and you know you have a letter of credit as collateral, you should become very much aware of the expiration date and the time for the bank to provide notice. You may have to start fishing around to find out whether notice has been given because knowing who the notice goes to can be a problem and sometimes that notice will go to underwriters or somebody else, and you don't learn of it timely. You really have to keep track of that because I can guarantee you that missing the date to draw on the letter of credit could cost all of us our jobs. There is too much at stake. You have to draw on it.

Furthermore, if there are claims being made post-petition against the bonds, and assuming that the surety can make multiple draws under the same letter of credit, the surety should draw on the letter of credit in an amount to cover the expected bond loss plus expenses and attorneys' fees. If during that very time, you get notice from the bank of non-renewal, then

of course, you should draw on the whole letter of credit. Finally, how can the surety use what it has drawn? If you draw $1,000,000 on the letter of credit, what can you use it for? You have rights under the indemnity agreement signed by the principal, you have rights under a collateral agreement if one was signed, which may be much more specific about the use of the collateral. You should know that those two agreements bind the debtor during his bankruptcy case, and you may act accordingly under those documents because the proceeds that you have obtained are not property of the debtor's estate.

UNEXPECTED OCCURS – WHAT HAPPENS TO THE EXCESS LETTER OF CREDIT PROCEEDS

Mike: Okay, in this next section, I'm going to talk about the unexpected. What happens to the excess letter of credit proceeds? Basically, the scenario is standard; you know you've gotten the letter of credit issued. After a while, maybe some reasons pop up for drawing down on it, such as the principal goes into bankruptcy; claims are made or the bank advises it is no longer going to renew the letter of credit. So, you draw down on it. After awhile, you've got some claims and some LAE costs and expenses; so you reimburse yourself for that. Now you're sitting there and you're holding a pot of money and you don't have any claims coming in at the moment and you're just sitting there. The question is what happens to that pot of money? Who gets those funds? Are they excess proceeds? Even if a bond is cancelled, of course as we all know, the surety still has the potential or contingent exposure under the bonds for that period of time when the bonds were effective. The question is important because many bankruptcy courts have held that although letters of credit are not property of the bankruptcy estate, excess proceeds from a letter of credit are property of the estate.

The way the courts have looked at it is they have reasoned that once the letter of credit has been drawn down, the independence principal is no longer at issue and the funds that are held by the beneficiary become subject to the underlying relationship between the beneficiary (in this case the surety) and the principal. So, the courts treat the proceeds as property of the bankruptcy estate. The courts have defined "excess proceeds" generally as proceeds of a letter of credit in excess of what is owed or what the beneficiary is legally entitled to receive or what the beneficiary needs to satisfy the underlying obligation. So, if you're holding funds that the court believes is in excess of what you're entitled to or what you need to secure yourself then the court may look at those proceeds as being excess proceeds.

In the suretyship context, because the surety continues to have that contingent or potential liability under its bond, the funds up to the penal sum of the bond should not be viewed as excess proceeds. George and I have fought this issue a number of times and a while back, we beat Skadden, Arps in a national bankruptcy on this issue. They were trying to get the proceeds and we're still holding those proceeds today. That's been, what seven years ago? Of course, the whole purpose of the letter of credit in the first place is to secure the surety against potential losses that the principal cannot indemnify or reimburse, so that purpose remains in place until the surety's liability under the bond is extinguished. The question then that is generated is when is the surety's liability extinguished? This issue comes up a number of times because the bankruptcy trustee sees the pot of money over there that the surety's holding and they just can't

wait to get their hands on it. They try to come up with all kinds of ways to get at it, so we end up fighting these battles. This issue of the excess proceeds really brings up the point that you need to have a detailed collateral agreement; a document that clearly defines what the collateral is being held for, and when that collateral is going to be released, under what terms and to whom. You really need to have those issues addressed in a good, thorough and detailed collateral agreement before you get the collateral in the first place.

In the absence of a collateral agreement, the surety must look to other factors to determine when its contingent liability will cease. It could be that upon the discharge of the bond by the obligee, the surety's liability will cease, and that's true in the case of a utility bond where there's only one potential claimant, and that's the obligee, and if the obligee discharges the bond, then there's no further liability. It could be the same thing where the obligee releases the surety. It could also be that the liability is extinguished upon payment of the penal sum of the bond. It might not be until the expiration of the applicable statute of limitations on a bond that the surety's liability is extinguished. That is particularly true in cases where there are third-party claimants potentially under the bond - for instance a contractor's licensing bond or a payment bond or even a liability for latent defects under the performance bond. You've got potential exposure out there, so the statute of limitations may be the only way to really be certain that your liability has been extinguished.

Of course the problem is that statutes of limitation vary by jurisdiction, and you've got to look at when does the claim accrue? Is it discovery or breach? What is the bond; is it a specialty, is it an instrument under seal - which statute of limitations is going to apply? Limitations is different in every jurisdiction and it becomes really murky as to when limitations have run. If the proceeds are excess and you have looked at the issue and you're convinced that your contingent liability is extinguished and you've got this situation now where there's excess money, who gets the money? Does the bank that issued the letter of credit get the money? Are they entitled to the return of the funds? Does the principal get the money? Are they out their collateral and they want to be reimbursed? Do they have a right to the funds? Does the trustee in bankruptcy have a right to get the funds back? This is a situation where the surety may find itself in the middle of two parties disputing who gets the money, and so the advice there is that the surety not take a risk and pay the wrong party, and that instead, an action be brought in the nature of an interpleader or some kind of declaratory judgment in order to determine where the money should be paid to protect the surety.

UNEXPECTED OCCURS – PREFERENCES IN A BANKRUPTCY PROCEEDING

George: We'd like to talk for a couple of minutes about preferences, because it is normally assumed that if you get the proceeds of the letter of credit, you won't have a preference. Unfortunately, that's not the case. The expected is that the letter of credit proceeds are not property of the debtor's estate and one of the prime elements of a preference is that the receiving party must receive property of the debtor's estate. The criteria for a preference is a transfer for the benefit of a creditor on account of an antecedent debt made within 90 days of the bankruptcy,

while the principal is insolvent, but the triggering aspect is that there has to be a transfer of property of the estate. While there are other conditions for the avoidance of a preference and certain defenses to a preference, the threshold issue is how can the surety receive letter of credit proceeds that are assets of the bank issuing the letter of credit and be found to be liable for that as a preference if the letter of credit proceeds are not property of the estate? Unfortunately, however, while a letter of credit or the proceeds of the letter of credit are not property of the debtor's bankruptcy estate, the principal's property, whether it is cash or otherwise, pledged as collateral to the bank issuing the letter of credit to the surety is property of the estate. This set of facts may result in a preference action being brought against the surety because the principal's obtaining the letter of credit with this collateral and giving that letter of credit to the surety is the payment of an antecedent debt.

This situation can be most clearly understood with an example. The principal executes the indemnity agreement in favor of the surety. The principal and the surety execute bonds. The principal then has a financial situation which is deteriorating and claims are made against the bond. The surety, under the indemnity agreement, demands collateral in the form of a letter of credit for $1,000,000. The principal then applies to the bank for that $1,000,000 letter of credit, and the bank requires $1,000,000 in cash to secure it. The principal supplies the cash and the bank issues the letter of credit to the surety. So, here are the three contracts we've been talking about; the principal and surety contract; the indemnity agreement and collateral agreement. The principal and the bank agree to provide the letter of credit for the principal but the principal hands over $1,000,000 in cash, the bank issues the $1,000,000 letter of credit to the surety. Let's assume then, that within 90 days, the principal becomes insolvent and files a bankruptcy, then the surety draws $1,000,000 on the letter of credit. Remember, those proceeds are the bank's assets, not assets of the principal or the debtor. However, as you know, the bank has the right and the ability to reimburse itself because it's got $1,000,000 in cash.

When you look at that factual situation, the courts have found that such a factual situation involving letters of credit proceeds and the principal's collateral provided to the bank all to secure an antecedent debt, which is what the surety is getting the letter of credit for, and which meet the other criteria of being a preference is an indirect transfer to the surety. Yes, there was an initial transfer from the principal to the bank to secure the letter of credit, but there's an immediate transferee, a second transfer that goes from the bank to the surety, and the bank gets out of the way. The courts have merely collapsed those three transactions into one transaction and ignore the independence principal. Unfortunately, in my opinion, these cases make sense. The surety was an unsecured creditor and made a demand under the indemnity agreement to get security and collateral or to be placed in funds for past obligations, its obligations under prior bonds. That is an antecedent debt. The bank is nothing more than the middleman. It gets its collateral, it issues the letter of credit, it realizes on the collateral and gets paid back. So, the surety, which was faced with an unsecured loss of $1,000,000 now has $1,000,000 in security, and the principal debtor is out $1,000,000 in cash. If all of the other elements of a preference action are met, despite the fact that the surety thinks it's holding a letter of credit proceeds as security which are not property of the estate, the bank may unwind the transaction and find that the surety in fact, has received a preference if this all occurs within the requirements of section 547. So, the question is should the surety demand and accept a letter of credit as collateral for an

antecedent debt? Absolutely "yes." You always take the collateral and keep your fingers crossed that more than 90 days will pass. What if the surety obtains a letter of credit for the issuance of new bonds? That's a different situation because one of the defenses to a preference is a contemporaneous exchange for new value. If the surety gets a letter of credit for new bonds and obligations, that means that the surety is providing new value and it is a defense to a preference. However, if the surety obtains a letter of credit, not only for the issuance of new bonds but also to cover potential losses and antecedent debts, namely prior executed bonds, that can be more problematic and there are a couple of cases that talk about that, which we will get to later. The risk when you take collateral like a letter of credit for both a new value and an antecedent debt is how is the court going to decide what it's for? That's a tough problem.