

DEBTOR/CREDITOR

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Standby Letter of Credit Creates Preference

A federal appeals court in Chicago recently created a \$31 million dollar windfall for a Chapter 11 debtor through its interpretation of the interplay between the bankruptcy and letter of credit law.

P.A. Bergner & Company (the future Chapter 11 debtor) entered into an agreement with Bank One Milwaukee under which Bank One issued a standby letter of credit to Associated Merchandising Corporation (“AMC”), a supplier of Bergner. The letter of credit provided that Bank One would pay AMC invoices which Bergner failed to pay on the presentation of appropriate documentation. The letter of credit also would be automatically renewed each year, unless Bank One provided notice of nonrenewal, in which case, AMC would have the right immediately to draw from Bank One the full amount provided under the letter of credit.

When Bank One became concerned over Bergner’s deteriorating financial condition, Bank One notified AMC that it would not renew the letter of credit. AMC promptly drew down the full amount remaining under the letter of credit (\$31 million) and held the funds on deposit as a credit against future purchases by Bergner. Bank One notified Bergner, which fulfilled its obligation to reimburse Bank One for the draw on the letter of credit. The net economic effect of the transaction was to prepay \$31 million worth of purchases from AMC.

After commencing its Chapter 11 case, Bergner sought to recover the payment to Bank One as a preferential transfer, because it was payment on a pre-existing debt within 90 days prior to bankruptcy while Bergner was

insolvent. Bank One argued that there was no preference, because Bergner received equivalent value for the payment from AMC’s credit.

The court reasoned that the transaction between Bank One and AMC and the transaction between Bergner and Bank One were independent of one another. Bank One’s obligation to pay AMC was independent of Bergner’s obligation to pay Bank One, in order that the standby letter of credit provide security of payment to AMC. For the same reason, Bergner’s receipt of credit from AMC was independent of any payment Bergner made to Bank One.

Because each part of the transaction was legally independent, the court viewed the payment from Bergner to Bank One as no more than a payment on a debt and required Bank One to return Bergner’s payment. Thus, Bergner received both \$31 million of credit from AMC and the return of the \$31 million it paid to Bank One. Had Bergner simply prepaid AMC directly, there would have been no preferential transfer.

Lenders may protect themselves from this type of situation by requiring their borrowers to pledge sufficient collateral to cover any potential draws under a standby letter of credit.

P.A. Bergner & Co. v. Bank One (In re P. A. Bergner & Co.), 140 F.3d 1111 (7th Cir. 1998).



This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

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