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When Collateral Is Gone, Can an Unsecured Secure Repayment?

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Vendors, landlords and contract counterparties know that when they have a distressed customer, each shipment on credit or each month of slow-pay rent increases the risk of nonpayment. Creditors are often without leverage to procure better credit terms or even a timely payment, which forces creditors to make difficult decisions: Should I stop shipping, should I terminate the lease, or should I put my customer in default?

Before taking the drastic measure of terminating the relationship with a customer or tenant, there are options to consider. This article analyzes the potential strengths and weaknesses between guaranties, surety bonds and letters of credit, each as options that might be available when a distressed customer or tenant has already pledged its collateral. This article also focuses on an unsecured creditor's ability to exercise such options after the customer's bankruptcy filing in light of automatic stay considerations and related risks.

Guaranties

Guaranties shift the risk of loss from the customer (the "primary obligor") to a third party (the "guarantor"). A distressed customer might be more easily convinced to provide a creditor with a guaranty from a third party that is not in distress than it would be to agree to "cash in advance" or "cash on delivery." A third-party guaranty, which guaranties payment as opposed to just collection,[1] can be ideal, as the plain language of § 362 of the Bankruptcy Code only stays proceedings directed "against the debtor."[2] Provided that the third-party guarantor is not itself a debtor, a creditor drawing on a guaranty obligation after its customer's bankruptcy filing should not be stayed.

Notwithstanding this straightforward analysis, some cases add complexity to this analysis. In "unusual situations," some courts extend the scope of the automatic stay to enjoin proceedings against nondebtor guarantors. The Fourth Circuit's opinion in *A.H. Robins Co. v. Piccinin* theorized that such an unusual situation would arise when "a suit is brought against a third party who is entitled to absolute indemnity by the debtor on account of any judgment that might result against [it] in the case."[3] The *A.H. Robins* court created automatic stay protections if "there is such an identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or a finding against the debtor,"[4] or "where proceedings against nondebtor co-defendants would reduce or diminish 'the property of the debtor [such as the debtor's insurance fund or pool] to the detriment of the debtors' creditors as a whole.'"[5]

Since issuing the *A.H. Robins* opinion, the Fourth Circuit has narrowed its interpretation of this issue in the *In re Credit Alliance Corp. v. Williams*[6] opinion, which holds that "[n]othing in § 362 suggests that Congress intended that provision to strip from the creditors of a bankrupt debtor the protection they sought and received when they required a third party to guaranty the debt."[7]

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1 A guaranty that provides only a guaranty of collection requires a guarantor to pay the creditor on the condition that the creditor first sought to collect from the principal obligor without results. As such, unless the creditor's collection efforts were started and unsuccessful pre-petition, the automatic stay would prevent the creditor from meeting the threshold requirements to invoke a guaranty of collection post-petition.

2 11 U.S.C. § 362(a).

3 *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 999 (4th Cir. 1986); *see also Okla. Federated Gold & Numismatics Inc. v. Blodgett*, 24 F.3d 136, 141 (10th Cir. 1994); *In re N. Star Contracting Corp.*, 125 B.R. 368, 370-71 (S.D.N.Y. 1991); *Robert W. Thomas & Anne McDonald Thomas Revocable Tr. v. Inland Pac. Colo. LLC*, No. 11-CV-03333-WYD-KLM, 2013 U.S. Dist. LEXIS 25952, at *6-*7 (D. Colo. Feb. 26, 2013); *In re Kanawha Trace Dev. Partners*, 87 B.R. 892, 896 (Bankr. E.D. Va. 1988).

4 *A.H. Robins*, 788 F.2d at 999.

5 *In re Credit Alliance Corp. v. Williams*, 851 F.2d 119, 121 (4th Cir. 1988) (quoting *A.H. Robins*, 788 F.2d at 1008, and reinterpreting same).

6 *Credit Alliance Corp.*, 851 F.2d at 121.

7 *Id. Credit Alliance Corp.* also highlights §§ 502(e) and 509 of the Bankruptcy Code. These sections function together to allow a guarantor (or surety) to elect to subrogate and rely on the original creditor's rights to assert its claims (§ 509) or elect to seek reimbursement of claims paid to the creditor (§ 502(e)), but not both. *Id.*

Finding a financially sound guarantor is another factor that an unsecured creditor should consider when seeking guaranty protections from a customer.[8] Guarantors often share a close relationship with their principal obligors, which explains the willingness to take on such exposure. However, when the principal obligor is suffering financially, all too often the guarantor is as well. While guaranties have such frailties, for an unsecured creditor looking at risk of nonpayment, guaranties can provide a relatively easily procured alternate source of payment.

Surety Bonds

Surety bonds require the customer to pay for an insurance policy to provide a creditor with protection. This might be a more difficult source of protection to negotiate with a struggling customer. However, the cost of a surety bond might be far less for the customer than finding a new supplier (if unique or difficult-to-procure items are involved), or procuring a surety bond might be less disruptive than having to find a new location for operations.

A surety bond functions as a guaranty from an insurance company. A creditor is given a surety bond to provide security for performance or payment. If the customer fails to perform or pay, possession of a surety bond allows the creditor to demand payment directly from the surety without having to involve the debtor. Once payment is made by the surety to the creditor, the surety may seek reimbursement from the original customer.[9] Similar to a third-party guaranty, when a creditor makes a demand from the surety rather than the debtor, the automatic stay is inapplicable.[10]

Notwithstanding the similarities to third-party guaranties, surety bonds take the form of conditional obligations. A surety bond will provide the surety certain notice and investigation rights, which can be the subject of protracted litigation.[11] In some instances, the surety may even have the right to step in and mitigate its damages.[12] With such rights preserved for the surety, calling for payment on a surety bond might be more challenging than making demand of a guarantor. However, if the creditor is successful in proving its right to payment on the bond, the likelihood of payment is far more certain than with a third-party guarantor.

Letters of Credit

Another type of creditor protection is a letter of credit. Like third-party guaranties and surety bonds, letters of credit shift the risk of loss to a third party. Like surety bonds, letters of credit are traditionally issued by creditworthy entities. The issuer of a letter of credit is likely to require security, in the form of collateral pledged by the customer, or require actual creditworthiness of the customer. A distressed customer may have trouble procuring this sort of protection for an unsecured creditor.

Letters of credit are distinct from third-party guaranties and surety bonds for the following reasons: (1) for a creditor to draw on a letter of credit, it must strictly comply with the specifications in the letter of credit;[13] and (2) letters of credit are independent obligations of the issuer, unrelated to the obligations of the customer and its creditor. This concept, applied to letters of credit, is referred to as "the independence principle."[14]

Relying on the independence principle, most bankruptcy courts recognize that a letter of credit itself and the proceeds are not property of a bankruptcy estate, making the automatic stay inapplicable.[15] After a bankruptcy filing, a creditor presenting a strictly compliant draw request on a debtor's letter of credit should be unquestionably honored by the issuer.[16] Thus, the issuer satisfies the letter-of-credit obligations due to the creditor from its own assets, then makes a claim against the debtor.[17]

However, some courts, relying on the concept that a creditor's security interest is considered property of the estate,[18] have reached confusing results when trying to apply the independence principle.[19] The Third Circuit has stated that "where the claim centers around the *collateral* pledged to the bank and *not* the distribution of the proceeds themselves, the 'fact that letters of credit themselves are not property of the estate is a red herring.'"[20]

In attempting to synthesize these disparate concepts, some opinions have focused on whether a debtor's assets were actually the collateral distributed to the creditor by the issuer of the letter of credit upon the draw.[21] However, as courts in Delaware continue to wade through these concepts, it seems that they have settled on the notion that when a creditor is seeking a letter of credit's proceeds, "it is not pursuing the pledged collateral ... the proceeds of a letter of credit are not property of the estate."[22] Under this reasoning, requesting a draw on a letter of credit should not be the subject of the automatic stay.

Other courts have extended the automatic stay to protect an issuer of a letter of credit if the issuer would obtain a secured position against the debtor by virtue of its payment to the creditor. If so interpreted, such draws could be subject to the automatic stay.[23] As with third-party guaranties, courts

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8 To be certain, a principal obligor's discharge of a guaranty obligation in bankruptcy does not destroy a guarantor's obligation to pay the creditor. However, a subsequent bankruptcy discharge in a guarantor's favor would eliminate the creditor's guaranty rights. 11 U.S.C. § 524(e); *see also Shure v. Vermont Indus. Dev. Auth. (In re Sure-Snap Corp.)*, 983 F.2d 1015, 1019 (11th Cir. 1993) ("[C]onfirmation of a debtor's Chapter 11 plan does not discharge obligations of a third-party guarantor."); *but see Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987) (confirmed reorganization plan provided release for third-party, non-debtor guarantor; release was not objected to by creditor; and release was upheld by Fifth Circuit's opinion).

9 *But see supra* fn. 7.

10 *See O'Malley Lumber Co. v. Lockard (In re Lockard)*, 884 F.2d 1171 (9th Cir. 1989) (contractor's surety bond not property of contractor debtor's estate); *Ohio v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)*, 660 F.2d 1108 (6th Cir. 1981) (surety bond to protect self-insured debtor's worker's compensation obligations was not subject to automatic stay).

11 *See, e.g., Nova Cas. Co. v. Turner Construction Co.*, 335 S.W.3d 698 (Tex. 2011) (discussing obligations of surety contract and enforcement of same).

12 *See, e.g., Granite Computer Leasing Corp. v. The Travelers Ins. Co.*, 894 F.2d 547 (2d Cir. 1990).

13 Assuming that the documents presented by the creditor to the issuer of the letter of credit comply with the specifications strictly set forth in the letter of credit, the issuer of the letter of credit must immediately, and without question, pay the creditor. The requirement of strict compliance can give rise to sometimes technical litigation risk. *See, e.g., In re Enron Corp. v. Banca Nazionale Del Lavoro v. Bank of Am. NA*, 292 B.R. 752 (Bankr. S.D.N.Y. 2003).

14 *See Demczyk v. Mut. Life Ins. Co. of New York (In re Graham Square Inc.)*, 126 F.3d 823 (6th Cir. 1997); *Kellogg v. Blue Quail Energy Inc. (In re Matter of Compton)*, 831 F.2d 586, 589 (5th Cir. 1987).

15 *See In re Stonebridge Techs. Inc.*, 430 F.3d 260 (5th Cir. 2005); *In re Papio Keno Club Inc.*, 247 B.R. 453, 459, 41 (B.A.P. 8th Cir. 2000), *judgment aff'd*, 262 F.3d 725, (8th Cir. 2001) (issuer satisfies letter-of-credit obligations from its own assets and not those of original obligor).

16 *But see Siegel v. Calif. Self-Insurers' Sec. Fund, et al. (In re Circuit City Stores Inc.)*, 2106 WL 1714515 (Bankr. E.D. Va. 2016) (confirming that Bankruptcy Code does not authorize creditor to keep more proceeds from letter of credit than it is owed).

17 *But see supra* fn. 7.

18 *In re Kaiser Group Int'l Inc.*, 399 F.3d 558, 566 (3d Cir. 2005) (quoting *Kellogg*, 831 F.2d at 590).

19 *See In re S-Tran Holdings Inc.*, 414 B.R. 28, 33 (Bankr. D. Del. 2009).

20 *Id.* (quoting *OCH Liquidation Trust v. Discover Re (In re Oakwood Homes)*, 342 B.R. 59, 67 (Bankr. D. Del. 2006)) (citations and internal punctuation omitted; emphasis in original)).

21 *In re S-Tran*, 414 B.R. at 34 (describing numerous conflicting considerations).

22 *Id.* (relying on *OCH Liquidation Trust*, 342 B.R. at 67 (quoting *In re Hechinger Inv.*, 282 B.R 149, 161 (Bankr. D. Del. 2002))).

23 *Matter of Twist Cap Inc.*, 1 B.R. 284, 285 (Bankr. M.D. Fla. 1979) (if drawing on letter of credit "amount[s] to an impermissible preferential treatment of ... two unsecured creditors [that] is contrary to the scheme of Chapter XI and would certainly be counterproductive to the debtor's efforts to obtain rehabilitation").

have also imposed the automatic stay to prevent the draw of a letter of credit to protect an issuer where there is a prerequisite to drawing that would violate the automatic stay.[24] However, if a distressed customer can (and will) deliver a letter of credit, and the creditor can have a role in drafting that letter of credit, that letter of credit should be able to withstand the automatic stay and provide excellent protection from credit risk under most circumstances.

Conclusion

In the final analysis, when weighing the potential litigation hurdles with a surety bond and the potential collection risk with a third-party guaranty, a well-drafted letter of credit seems to be a superior form of risk-mitigation for an unsecured creditor. The clear collectability of a letter of credit requires more from the customer at the outset. However, keeping in mind the context where this analysis started, from the perspective of a creditor with no risk-mitigation measures in place, even the flaws of a third-party collection guaranty or the litigation risk of a surety bond are meaningful improvements worthy of requesting from a distressed customer. abi

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24 *See supra* fn. 1; *see also In re Metrobility Optical Sys. Inc.*, 268 B.R. 326, 330 (Bankr. D.N.H. 2001) (requiring demand on debtor prior to presentment would violate automatic stay); *Shanri Holdings Corp. v. Kmart Corp. (In re Kmart Corp.)*, 297 B.R. 525, 530-32 (N.D. Ill. 2003) (if debtor is in control of letter of credit, creditor's attempt to exercise control would violate automatic stay).