Proceeds from an Assignment of Your Customer's Letter of Credit – Are They Preferential Transfers?

By

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A letter of credit (L/C) may be broadly defined as an undertaking by an issuer, the bank, to pay a third party, the creditor who is the beneficiary for the account of the bank's customer, the debtor, when the creditor submits documents specified by the L/C. An L/C may serve as a guarantee, securing performance of an obligation with a bank's commitment to pay upon presentation of a draft, default notice or other documents specified by the L/C.

Recent bankruptcy decisions have addressed the issue of whether the proceeds from an L/C are preferential when the beneficiary to the L/C is the creditor. These decisions have held that such proceeds are not preferential when the L/C is issued prior to the start of the preference period. But what about a situation where the debtor is the beneficiary and the debtor assigns its interests in the L/C to its creditors? These are the facts in the recent case of *In re Cooper Mfg. Corp.*

In *Cooper*, the Texas bankruptcy court faced the issue of whether the proceeds from an assigned L/C were preferential transfers when the assignment from the debtor to its creditors occurred prior to the start of the preference period, but the proceeds were received by the creditors within the preference period. The Chapter 7 trustee brought adversary proceedings to recover, as preferential, transfers made to four creditors under an alleged assigned L/C. The trustee moved for partial summary judgment, and two creditors cross-moved for partial summary judgment.

In ruling on the summary judgment motions, the court analyzed the issue of the assignment and prior decisions relating to assignments. To support his argument, the trustee primarily relied on the case of *Diversified World Investments, Limited v. Omni International, Limited*. In *Diversified,* the court held that the transfer occurred when the payment was made pursuant to an assignment of rental payments. The debtor in *Diversified* assigned its right to payment under an aircraft lease agreement to a creditor. The assignment took place outside the preference period, but the payment was received by the creditor within 90 days of the bankruptcy filing. The *Diversified* court believed that Section 547(e)(3) was intended to bring payments made pursuant to an assignment within the term "transfer" because, under Section 101(40) of the Bankruptcy Code, the term transfer was intended to be as broad as possible.

The court in *Cooper* determined that the *Diversified* court confused the contractual right to receive payment with the right to demand actual payment, citing that a beneficiary of a letter of credit has a contractual right to the proceeds once the letter of credit is issued. Accordingly, the debtor had a right to the LOC proceeds before it made the assignments, and the transfers occurred when debtor assigned LOC proceeds to creditors, not on date on which creditors actually received proceeds. The court concluded that for the purpose of calculating the preference period under Section 547(b), a transfer occurs on the date the contractual right to the proceeds is assigned, not on the date the payment is actually made.