BONDING AGAINST BANKRUPTCY: PROTECTING JUDGMENTS PENDING APPEAL

ALAN J. FRIEDMAN AND MICHAEL P. MCMAHON*

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* Alan J. Friedman is a partner in the Newport Beach office of Irell & Manella LLP and a member of the firm's bankruptcy, reorganization and creditor's rights practice. Michael P. McMahon is an associate in the same office and also a member of the bankruptcy, reorganization and creditor's rights practice.

INTRODUCTION

Filing an appeal generally does not prevent a prevailing party from enforcing a judgment. Depending on the size of the judgment and the length of time the appeal remains pending, enforcing the judgment may render the appeal moot before the appeal is even heard. The traditional solution is for the appellant to post a supersedeas bond to obtain a stay of the judgment pending the appeal.[1] The appellant thus protects its right to a meaningful appeal, and the appellee is assured of a source of payment to satisfy its judgment in the event that the appeal fails. As the judgment gets larger, however, so too does the price of the bond. Moreover, the bonding company may require the appellant to post a letter of credit to secure the bond, adding a second layer of expense. Appellees have an incentive to reduce the appellant's costs because the appellee may be forced to reimburse the appellant if the appeal results in a reversal.[2]

Therefore, appellants and appellees are increasingly pursuing lower-cost alternative appellate securities—in particular, escrows and standby letters of credit. Courts have shown a willingness to bless such arrangements, especially when the parties agree on the alternative security. Before a judgment creditor agrees to an alternative security, however, it must consider how that security would be treated in the event that the appellant becomes involved in a bankruptcy proceeding. Since the potential insolvency of the judgment debtor is a principal reason for requiring the appellate security in the first instance, one would expect that bankruptcy courts would not allow a bankruptcy filing during the pendency of the appeal to disturb the bargained-for agreement of the parties. Yet, even in the case of supersedeas bonds, bankruptcy courts have struggled with how to handle the appellate security when the judgment debtor files its bankruptcy petition (or has a petition filed against it) prior to resolution of the appeal. When an alternative appellate security is involved, the result may be even more uncertain.

This Article begins with a discussion of the importance of bankruptcy-proofing the appellate security and the potential consequences of failing to do so. The Article then compares how bankruptcy courts have handled each of the primary options for an appellate security—supersedeas bonds, escrows, and standby letters of credit—and discusses the bankruptcy-related issues and considerations particular to each.

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[1] *See* FED. R. CIV. P. 62(d) ("If an appeal is taken, the appellant may obtain a stay by supersedeas bond.").

[2] FED. R. APP. P. 39(a)(3) (providing "if a judgment is reversed, costs are taxed against the appellee").

I. REQUIREMENTS FOR AN EFFECTIVE APPELLATE SECURITY

There are two principal requirements that any appellate security must meet in order to minimize the potential impact of a bankruptcy petition filed by or against the judgment debtor[3] during the pendency of the appeal. First, the security must be insulated from becoming property of the judgment debtor's bankruptcy estate.[4] This requires divesting the debtor of any property rights in the security. Second, the security must not give rise to liability for a preferential or fraudulent transfer.[5] The debtor's pledge of its property as collateral for the supersedeas bond or other security may be deemed to be an indirect transfer to the appellee for whose benefit the security was obtained. As discussed below, however, except in the unlikely event that the bankruptcy petition is filed during the 90-day preference window,[6] such liability is likely to arise only if another entity, such as an affiliate of the debtor, pledges the property on the debtor's behalf and becomes involved in its own bankruptcy petition, either voluntary or involuntary.[7]

A. Keep the Security Outside of the Bankruptcy Estate

Pursuant to section 541(a) of the Bankruptcy Code,[8] property of the estate is broadly defined to include, subject to limited exceptions, "all legal or equitable interests of the debtor in property as of the commencement of the case."[9] The existence and nature of the debtor's interest in property is defined by applicable state law, generally the law of the state where the property is located.[10] If the appellate security is found to be property of the estate under section 541(a), or recoverable under one of the avoidance statutes,[11] the judgment creditor would

[3] In this Article, unless the context requires otherwise, the terms "judgment debtor" (or just "debtor") and "appellant" are synonymous. Likewise, "judgment creditor" and "appellee" are used interchangeably.

[4] *See* 11 U.S.C. § 541 (2012).

[5] *See* 11 U.S.C. §§ 544, 547 & 548.

[6] *See* 11 U.S.C. § 547(b)(4).

[7] Creditors could even file an involuntary bankruptcy petition against the affiliate to prompt recovery of the transfer.

[8] The Bankruptcy Code is found in title 11 of the United States Code. Unless otherwise indicated, references to statutory sections in this Article are to the Bankruptcy Code.

[9] 11 U.S.C. § 541(a)(1).

[10] *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law."); *In re* Carmania Corp., N.V., 154 B.R. 160, 163 (S.D.N.Y. 1993) ("A security interest in rents is defined by reference to the law of the state in which the real property is located.").

[11] *See, e.g.*, 11 U.S.C. § 544(b) (incorporating applicable state law avoidance statutes); 11 U.S.C. § 547(b) (providing for avoidance of preferential transfers); 11 U.S.C. § 548(a) (providing for

be stayed from seeking to execute on the security by the automatic stay of section 362(a)(2).[12] Moreover, any proceeds would be distributed according to the priority scheme established by the Bankruptcy Code.[13] Depending on the nature of the judgment[14] and the debtor's financial condition, the judgment could be worth pennies on the dollar, if anything, as a result of the bankruptcy filing.[15]

B. Avoid Preferential or Fraudulent Transfer Exposure

Attempts to transfer property pre-petition by the debtor may be undone as preferential or fraudulent transfers.[16] This includes the taking of a security interest in property of the debtor[17] and the transfer of a property interest to a third party for the judgment creditor's benefit.[18] Importantly, however, the avoidance statutes apply only to "an interest of the debtor in property."[19] Thus, if the debtor has no property interest in the appellate security, any payout on

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avoidance of fraudulent transfers). 11 U.S.C. § 550(a) (providing for recovery of avoided transfers "for the benefit of the estate").

[12] *See* 11 U.S.C. § 362(a)(2) (applying automatic stay to "the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title").

[13] *See* 11 U.S.C. § 726(a) (indicating priority of distributions in chapter 7 liquidation); 11 U.S.C. § 726(b) (stating distributions are pro rata within each class); 11 U.S.C. § 1123(a)(4) (providing chapter 11 plan must treat each member within class equally); 11 U.S.C. § 1129(b) (stating absolute priority rule for any nonconsensual chapter 11 plan).

[14] A judgment based on securities fraud, for instance, is particularly vulnerable because such judgments are subject to mandatory subordination. *See* 11 U.S.C. § 510(b).

[15] The judgment creditor should, of course, attempt to improve its position by recording a judgment lien against the debtor's property under state law. But the judgment would become secured only up to, at most, the equity in the debtor's property. *See* 11 U.S.C. § 506(a)(1); *see also* 11 U.S.C. § 547(b) (providing avoidance of transfers of property interests made within 90 days of the bankruptcy filing); 11 U.S.C. § 550(a) (providing recovery of avoided transfers "for the benefit of the estate"); 11 U.S.C. § 510(c)(2) (transferring liens securing subordinated claims to estate).

[16] *See* 11 U.S.C. § 544(b)(1) (avoiding fraudulent transfers under applicable state law); 11 U.S.C. § 547(b) (avoiding preferential transfers within 90 days of filing); 11 U.S.C. § 548(a) (avoiding fraudulent transfers within two years of filing); 11 U.S.C. § 550(a) (recovering transfers avoided under foregoing sections for benefit of bankruptcy estate).

[17] *See supra* note 15.

[18] "Transfer" is broadly defined under both the Bankruptcy Code and the Uniform Fraudulent Transfer Act ("UFTA"), and encompasses "direct or indirect" transfers. *See* 11 U.S.C. § 101(54); UNIFORM FRAUDULENT TRANSFER ACT § 1(12) (1984); *see also* Kellogg v. Blue Quail Energy, Inc. (*In re* Compton Corp.), 831 F.2d 586, 591–592 (5th Cir. 1987) ("The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party."); *accord In re* Air Conditioning, Inc. of Stuart, 845 F.2d 293, 296 (11th Cir. 1988) (indicating that an indirect transfer to a third party may constitute a voidable preference).

[19] 11 U.S.C. §§ 544(b)(1), 547(b), 548(a)(1). Sections 544(b) and 548(a) also provide for recovery of an "obligation incurred by the debtor." 11 U.S.C. §§ 544(b)(1) & 548(a)(1).

account of the security—such as collecting from a surety, escrow agent, or issuer of a letter of credit—would not be subject to the avoidance statutes.[20]

On the other hand, the debtor's transfer of property to obtain the security—such as the pledging of collateral as security for a bond or letter of credit or the depositing of property into an escrow account—could be subject to avoidance as an indirect transfer to the judgment creditor.[21] The exposure to preference liability, however, should be minimal given the length of the appellate process and the limited 90-day window for recovering non-insider pre-petition transfers as preferences.[22] Likewise, fraudulent transfer exposure should be minimal because, absent actual fraudulent intent, liability may be imposed only if the debtor does not receive "reasonably equivalent value,"[23] and "value" is defined to include securing an antecedent debt.[24]

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[20] *See In re* Southmark Corp., 138 B.R. 820, 828–30 (Bankr. N.D. Tex. 1992) (holding receipt of bond proceeds in satisfaction of judgment did not involve transfer of interest of the debtor and thus did not trigger liability as a preferential or fraudulent transfer, notwithstanding that bond was secured by debtor's property); Carlson v. Farmers Home Admin. (*In re* Newcomb), 744 F.2d 621, 626–27 (8th Cir. 1984) ("Given the unavoidable transfer that occurred when the escrow was created, the transfer that occurred when the condition of the escrow was met is not the type of transfer that can be avoided."); *In re Compton*, 831 F.2d at 589 (explaining "a bankruptcy trustee is not entitled to enjoin a post-petition payment of funds under a letter of credit from the issuer to the beneficiary, because such a payment is not a transfer of debtor's property").

[21] *See supra* note 18; *see also Southmark,* 138 B.R. at 825–26 (noting transfer occurred on date of perfection of security interest pledged to obtain bond); *In re* Coco, 67 B.R. 365, 369 (Bankr. S.D.N.Y. 1986) ("[T]he escrow cases are uniform in holding that it is the debtor's *deposit* of funds into escrow and not the award of judgment or subsequent release of the funds that is the controlling transfer for preference purposes."); *In re Compton*, 831 F.2d at 595 ("The indirect transfer . . . occurred . . . when the letter of credit was issued and the increased security interest was pledged."). Furthermore, the transfer may be recovered from "the entity for whose benefit such transfer was made." 11 U.S.C. § 550(a)(1).

[22] *See* 11 U.S.C. § 547(b)(4). If, however, a petition is filed by or against the judgment debtor within 90 days, the requirements for recovery of a preferential transfer may be satisfied. *See In re* Thermoview Indus. Inc., 358 B.R. 330, 333–36 (Bankr. W.D. Ky. 2005) (finding a transfer of funds to obtain a supersedeas bond was an avoidable preference when the debtor filed a chapter 11 petition two months after posting the bond). The other requirements for preference liability are that the transfer is "to or for the benefit of a creditor," 11 U.S.C. § 547(b)(1); the transfer is "for or on account of an antecedent debt," 11 U.S.C. § 547(b)(2); the transfer was "made while the debtor was insolvent," 11 U.S.C. § 547(b)(3); and the transfer enables the creditor to receive more than it would through a chapter 7 liquidation absent the transfer, 11 U.S.C. § 547(b)(5).

[23] *See* 11 U.S.C. § 548(a)(1)(B)(i); UFTA §§ 4(a)(2) & 5(a). The other requirement for constructive fraudulent transfer liability to attach is that the debtor is insolvent—on either a balance sheet, cash flow, *or* adequate capital basis—*or* becomes insolvent under either test as a result of the transfer. *See* 11 U.S.C. § 548(a)(1)(B)(ii)(I); UFTA §§ 4(a)(2) and 5(a).

[24] *See* 11 U.S.C. § 548(d)(2)(A); UFTA § 3(a). Although "reasonably equivalent" is not defined in either the Bankruptcy Code or the UFTA, a security interest granted to secure an antecedent debt has been held to qualify. *In re* Anand, 210 B.R. 456, 460 (Bankr. N.D. Ill. 1997), *aff'd*, Anand v. Nat'l Republic Bank of Chi, 239 B.R. 511 (N.D. Ill. 1999) (holding under section 548, pledging new collateral for existing debt is not transfer in exchange for less than reasonably equivalent value

The immunity to fraudulent transfer liability, however, applies only with respect to the bankruptcy of the judgment debtor. If a third party, such as an affiliate of the debtor, pays the premium, pledges the collateral, or deposits the escrow property on the debtor's behalf, the judgment creditor could be subject to fraudulent transfer liability in the third party's bankruptcy based on a lack of reasonably equivalent value *to the third party*.[25] It is possible, but by no means certain, that an affiliate of the debtor could receive an indirect benefit from assisting the judgment debtor.[26] The judgment creditor would be unwise to rely on such an indirect benefit to avoid fraudulent transfer liability. Rather, to the extent possible, the judgment creditor should ensure that the pledged or deposited property originates from the judgment debtor, or at a minimum comes from a solvent affiliate.[27] In the context of an alternative appellate security, the judgment creditor may be able to leverage its ability to withhold consent to the alternative security in order to obtain such assurances from the judgment debtor. Because consent is unnecessary for a judgment debtor to post a supersedeas bond, it may be impossible to obtain such assurances in the bond context.

II. THE BASELINE: SUPERSEDEAS BONDS

As discussed in this section, a supersedeas bond would likely satisfy all of the requirements for an effective appellate security, the potential cost notwithstanding. An appellant's interest in a supersedeas bond is minimal and becomes fully divested upon an unfavorable ruling by the appellate court.[28]

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regardless of value of collateral because creditor's interest in collateral could not exceed debt owed to it); *In re* Oakwood Homes Corp., 342 B.R. 59, 70–71 & 71 n.4 (Bankr. D. Del. 2006) (allowing leave to amend action under section 544 to allege that transfer of collateral for letter of credit, as opposed to the subsequent draw, was a fraudulent transfer, but noting that such "claim may have a problem with the reasonably equivalent value issue"); *cf. In re* Applied Theory Corp., 330 B.R. 362, 363 (S.D.N.Y. 2005) (upholding "the *per se* rule consistently applied in this District, which provides that a debtor's grant of security interest in its assets to a lender who has previously given the debtor a cash loan may not be considered a fraudulent conveyance" under the Bankruptcy Code or New York's Fraudulent Conveyance Act).

[25] This situation should not implicate preference liability because the debtor in this instance would not have owed an antecedent debt. *See* 11 U.S.C. § 547(b)(2) (requiring a transfer be made "for or on account of an antecedent debt owed by the debtor" in order for a trustee to avoid such transfer).

[26] *Cf.* Leibowitz v. Parkway Bank & Trust Co. (*In re* Image Worldwide, Ltd.), 139 F.3d 574, 579–80 (7th Cir. 1998) (recognizing indirect benefit to corporate parent from guarantying subsidiary's debt *may* constitute "reasonably equivalent value," but finding no consideration for the guarantee in that case); Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (*In re* TOUSA, Inc.), 680 F.3d 1298, 1310–13 (11th Cir. 2012) (upholding factual determination by bankruptcy court that liens transferred to lenders by subsidiaries of borrower were not transferred for reasonably equivalent value under circumstances of case).

[27] *See supra* notes 23 and accompanying text.

[28] *See infra* note 44 and accompanying text.

Even a bankruptcy filing prior to conclusion of the appeal would be unlikely to prevent the proceeds of the bond from being distributed to the appellee if it ultimately succeeds in the appeal. Subject to the caveat mentioned at the end of this section, a supersedeas bond should also have minimal exposure to being avoided as a preferential or fraudulent transfer. Moreover, supersedeas bonds are generally treated similarly to one another in bankruptcy, minimizing any concern about properly structuring the transaction or needing to rely on interpretation of state property law concepts.[29]

A. Property of the Bankruptcy Estate

In *Mid-Jersey National Bank v. Fidelity-Mortgage Investors*,[30] decided under the superseded Bankruptcy Act of 1898, the court ruled that a certificate of deposit, which had been deposited with a district court in lieu of a supersedeas bond,[31] was not property of the bankruptcy estate and that the appeal was not subject to the bankruptcy stay.[32] The court likened the certificate of deposit to the res of a trust and held that the debtor retained only a "contingent reversionary interest as a potential beneficiary of the trust."[33] Thus, the court reasoned, the appeals at issue did not impact the bankruptcy proceedings and were not stayed.[34]

Most courts have held that *Mid-Jersey*'s holding, at least with respect to application of the automatic stay, did not survive enactment of the Bankruptcy Code in 1978.[35] Thus, the automatic stay would apply to an appeal filed by the

[29] Unlike in the escrow context, the reported decisions suggest that the appellant's interest in a supersedeas bond is not dependent on unique state law. Accordingly, determination of the applicable state law is not a significant issue in any of the opinions discussed in this section, as evidenced by the courts' lack of discussion regarding state law in this context.

[30] 518 F.2d 640 (3d Cir. 1975).

[31] Although *Mid-Jersey* did not actually involve a supersedeas bond, it is widely cited in cases that do. *See, e.g.*, *In re* Celotex Corp., 128 B.R. 478, 480 (Bankr. M.D. Fla. 1991) ("The genesis of any review of whether a supersedeas bond is property of the estate is the pre-Code decision of the Court of Appeals for the Third Circuit in *Mid-Jersey National Bank v. Fidelity-Mortgage Investors*.").

[32] *Mid-Jersey*, 518 F.2d at 644 (finding that the appeal was not subject to the bankruptcy stay because the certificate of deposit was not property of the bankruptcy estate).

[33] *Id.*

[34] *Id.*

[35] *See* Borman v. Raymark Indus., Inc., 946 F.2d 1031, 1037 (3d Cir. 1991) ("We believe *Mid-Jersey* is no longer an accurate statement of the law to the extent it holds that a supersedeas bond or deposit can prevent the application of the automatic stay."); Raymark Indus., Inc. v. Lai, 973 F.2d 1125, 1131 (3d Cir. 1992) (overturning appellate rulings for being in violation of automatic stay, notwithstanding that rulings were entered prior to the *Borman* decision, because *Mid-Jersey*'s holding was overturned by passage of Bankruptcy Code, not *Borman* decision); *In re Celotex Corp.*, 128 B.R. at 481 ("The *Mid-Jersey* court, considering pre-Code law, did not have before it the expansive views established by Congress in Section 541 and Section 362 of the Bankruptcy Code."); *see also* Sheldon

debtor pre-petition that remains pending at the time of the bankruptcy filing, regardless of whether a supersedeas bond or alternate security has been posted.[36]

Moreover, the continuing validity of *Mid-Jersey*'s holding with respect to the property of the bankruptcy estate is also questionable.[37] In *Borman v. Raymark Industries, Inc.*,[38] the court made clear that "[w]e express no opinion on whether the supersedeas bond is considered property of the bankruptcy estate under the Bankruptcy Code."[39] But *Borman* does recognize the criticism of other courts on *Mid-Jersey*'s holding, "especially in light of the expansive definition of 'property of the estate' under § 541."[40] For one, courts have noted that "basic property law would suggest a reversionary interest is never contingent but is vested subject to divestment."[41] Second, even a debtor's equitable interest as beneficiary of a hypothetical trust, as described in *Mid-Jersey*, would fall within the broad definition of property of the estate under section 541(a).[42]

But even if the supersedeas bond is technically property of the estate, courts are generally in agreement that the bankruptcy estate's interest is limited to a reversionary interest subject to divestment.[43] Thus, there is little doubt that

v. Munford, Inc., 902 F.2d 7, 8 (7th Cir. 1990) (holding an appeal initiated by debtor and secured by a supersedeas bond was subject to automatic stay). *But see In re* Royal Bus. Sch., Inc., 157 B.R. 932, 939 (Bankr. E.D.N.Y. 1993) (holding a post-petition appellate ruling was valid even though no relief from automatic stay had been granted because appeal had been initiated by debtor, and therefore did not constitute an action against the debtor under 11 U.S.C. § 362(a)(1)).

[36] In such case, upon the filing of a proper motion under section 362(d) of the Bankruptcy Code, the court would likely grant relief from the automatic stay to proceed with the appeal. *See Sheldon*, 902 F.2d at 9 (noting bankruptcy court would presumably lift automatic stay since debtor "is the appellant and if it wins its creditors will be better off.").

[37] *See Mid-Jersey*, 518 F.2d at 643 (holding certificate deposit, used in lieu of supersedeas bond, is not property of debtor).

[38] 946 F.2d 1031 (3d Cir. 1991).

[39] *Id.* at 1037.

[40] *Borman*, 946 F.2d at 1034. *See also supra* note 35.

[41] *Id.* at 1034 (quoting *In re Celotex Corp.*, 128 B.R. at 480); *see also In re* Duplitronics, Inc., 183 B.R. 1010, 1014 (Bankr. N.D. Ill. 1995) ("The appellant retains a reversionary interest in the bond subject to divestment.").

[42] *See Borman*, 946 F.2d at 1034 (citing *In re Celotex, Corp.*, 128 B.R. at 480–81).

[43] *See In re Celotex Corp.*, 128 B.R. at 482.

> If at the time of filing the petition the appellate process has not been concluded, the debtor still has an interest in the supersedeas bond cognizable under Section 541 of the Bankruptcy Code subject to the interest being divested if the debtor is unsuccessful once the appellate process is completed.

Id.; *In re Duplitronics, Inc.*, 183 B.R. at 1014; *see also* Edwards v. Armstrong, 6 F.3d 312, 316 (5th Cir. 1993), *rev'd on other grounds sub nom*. Celotex Corp. v. Edwards, 514 U.S. 300 (1995) ("A defendant who posts a supersedeas bond retains a reversionary interest in the bond subject to divestment."); *In re* Keene Corp., 162 B.R. 935, 942 (Bankr. S.D.N.Y. 1994) ("The debtor retains a affirmance of the appealed judgment pre-petition fully divests the debtor of any interest in the supersedeas bond and prevents it and its proceeds from becoming property of the bankruptcy estate.[44]

By this same logic, resolution of the appeal against the debtor post-petition, pursuant to an order lifting the automatic stay, should likewise divest the bankruptcy estate of any interest it may have had in the bond and its proceeds.[45] A debtor's reversionary interest in a supersedeas bond has value *only* if the debtor succeeds in its appeal. A bankruptcy filing does not "enlarge a debtor's rights against others beyond those existing at the commencement of the case . . . . Thus, a debtor may not use Section 541(a) to divest another of property to which they rightfully have title."[46]

Hence, the estate's interest in the supersedeas bond, which is limited to that of the debtor pre-petition, terminates upon an unfavorable appellate decision, and it should not matter whether the appeal is resolved before or after the bankruptcy filing. In either event, the bankruptcy should not prevent the judgment creditor from collecting the bond proceeds from the surety, assuming

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reversionary interest in an appeal bond subject to divestiture if the debtor is unsuccessful once the appeal process has been completed.").

[44] *See* Willis v. Celotex Corp., 978 F.2d 146, 149 (4th Cir. 1992) (finding it unnecessary to decide whether a supersedeas bond may be property of the estate because "the appeal was decided unfavorably to . . . [the debtor] and our mandate issued prior to . . . [its] bankruptcy filing, thus extinguishing any interest . . . [the debtor] may have had in the bond."); *see In re* Keene, 162 B.R. at 942 ("If that appeal has been completed prior to the filing of the petition, and the debtor has been divested of its reversionary interest, the debtor does not have an interest in the bond that is property of the estate.").

[45] *See In re* Celotex, 128 B.R. at 482 ("Where a debtor, upon the filing of the bankruptcy petition, is an unsuccessful appellant in the total appellate process, *or during the bankruptcy case is unsuccessful in its appeal*, its property interest in the bond can be divested") (emphasis added); *In re* Central Medical Center, Inc., 122 B.R. 568, 573 (Bankr. E.D. Mo. 1990) (denying confirmation of plan because it sought to utilize proceeds of fund in which debtor held only reversionary interest and thus "violate[d] Section 541(a) due to its improper expansion of the estate's interest in the Fund."). As discussed in Part V, *infra*, the *Celotex* court actually enjoined the judgment creditors from collecting from the sureties notwithstanding the finding that the debtor and estate held only a reversionary interest subject to divestment.

[46] *See In re Central Medical Center*, 122 B.R. at 573 (quoting *In re* N.S. Garrott & Sons, 772 F.2d 462, 466 (8th Cir. 1985) (internal quotation marks omitted); *see also In re Celotex*, 128 B.R. at 482; Mid-Atl. Supply, Inc. of Va. v. Three Rivers Aluminum Co., 790 F.2d 1121, 1125 (4th Cir. 1986).

> When a debtor holds only bare legal title as a consequence of imposition of a constructive trust, then it is only that bare title which becomes property of the estate under section 541. . . . Legal title alone has been held to be of no value to the estate and the debtor will be required to reconvey the property or its substitute to the beneficial owner.

Id.

that the bankruptcy court has granted appropriate relief from the automatic stay or determined that it does not apply.[47]

B. Preferential and Fraudulent Transfer Liability

As noted above, exposure to liability for a preferential or fraudulent transfer should be minimal *unless* the property pledged as collateral for the bond comes from an entity other than the judgment debtor.[48] Because the judgment debtor has the statutory right to post the supersedeas bond, the judgment creditor is unlikely to have any control over the source of the bond premium or collateral posted as security. If controlling the source of the property or funds is an issue, the judgment creditor may wish to avoid the supersedeas bond by proposing a potentially less costly alternative appellate security and then conditioning its consent to the alternative security on the judgment debtor making assurances as to the source of the property or funds.[49]

III. ALTERNATIVE APPELLATE SECURITIES

Particularly for the largest of judgments, appellants and appellees may seek to avoid costly supersedeas bond premiums by considering alternative arrangements. Although the appellant must pay the bond premium in the first instance, the appellee may be required to reimburse the amounts paid if the appellate court rules in the appellant's favor.[50] Fees paid for alternatives to supersedeas bonds are generally treated the same as bond premiums, at least if the parties agree to the alternative and its cost is no greater than the bond premium would have been.[51] Thus, both parties to the appeal may benefit from a

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[47] *See supra* note 36 (discussing relief from automatic stay to proceed with appeal).

[48] *See supra* Part II.B. In the unlikely event of a bankruptcy filing within 90 days of posting the bond, however, preference liability may attach. *See supra* note 22; Thermoview Indus. Inc., 358 B.R. 330, 333–36 (Bankr. W.D. Ky. 2005).

[49] Further, the judgment creditor may require an opinion of counsel as to the non-avoidability of the transfers creating and securing the alternative appellate security.

[50] *See* FED. R. APP. P. 39(a)(3) ("[I]f a judgment is reversed, costs are taxed against the appellee").

[51] *See id.* (including as costs "premiums paid for a supersedeas bond *or other bond to preserve the rights pending the appeal*") (emphasis added); *see also* Republic Tobacco Co. v. N. Atl. Trading Co., 481 F.3d 442, 449–50 (7th Cir. 2007) (taxing costs for loan posted in lieu of supersedeas bond and noting costs were not in addition to cost of supersedeas bond and did not exceed cost of a bond); Johnson v. Pac. Lighting Land Co., 878 F.2d 297, 298 (9th Cir. 1989) ("Where a letter of credit has been used and the total cost has been no greater than a supersedeas bond without collateral, the charge for the letter of credit has been treated as the equivalent of premiums paid for the cost of a supersedeas bond.") (citing Bose Corp. v. Consumers Union of U.S., Inc., 806 F.2d 304, 305 (1st Cir. 1986)).

less costly alternative security.[52] The appellant, however, may have an even greater incentive to avoid a supersedeas bond because the surety may require the appellant to secure the bond with a standby letter of credit, which in turn carries its own fee.[53] Courts have held that a successful appellant may not be able to recover this second layer of expense even when the added expense was required to obtain the bond.[54]

This Article focuses on two of the more common alternative appellate securities—escrows and standby letters of credit—and discusses the risks, benefits, and unique considerations of each associated with a bankruptcy filing involving the appellant.

A. Escrows

If properly executed, an escrow used as an appellate security *should* be treated in the same manner as a supersedeas bond in a bankruptcy filing involving the appellant. Reported decisions, however, suggest that the treatment of escrows is less certain and more dependent on state law property rights.[55] An appellee considering this option should carefully scrutinize the language in the escrow agreement.[56] One of the advantages of the escrow may be the ability to

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[52] *See, e.g.*, Smart Mktg. Grp., Inc. v. Pubs. Int'l, Ltd., No. 04-cv-0146 2011, WL 1897214, at *2 (N.D. Ill. May 17, 2011) (taxing costs of fee paid for letter of credit posted in lieu of supersedeas bond and noting it was chosen "because it was more economical than obtaining a supersedeas bond").

[53] *See infra* Part IV.B.

[54] *See Johnson*, 878 F.2d at 298 (denying recovery of fee paid for standby letter of credit because it was paid *in addition to* premium for the bond as opposed to being paid as substitute); *accord* Hynix Semiconductor, Inc. v. Rambus, Inc., No. C-00-20905, 2012 WL 95417, at *5 (N.D. Cal. Jan. 11, 2012) (holding bond premium recoverable but fees for standby letters of credit required to be posted as security for bond not recoverable).

[55] *See supra* note 29.

[56] As a preliminary matter, because an escrow involves a contractual arrangement, the appellant must ensure that the escrow agreement does not require material future performance from both parties. Otherwise, the agreement could be deemed an executory contract, which may give a trustee or debtor in possession the ability to reject the contract. *See* 11 U.S.C. § 365(a) (2012) (allowing a trustee to "assume or reject any executory contract or unexpired lease of the debtor"); *see also* Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp., 872 F.2d 36, 39 (3d Cir. 1989) (finding service agreement between debtor and National Fuel, which included continuing reciprocal obligations, was an executory contract subject to rejection under section 365). However, because the grantor's obligations are, in the usual case, essentially completed upon depositing the funds with the escrow agent, and the grantee generally has no obligations under the escrow agreement, courts consistently hold that escrow agreements are not executory and may not be rejected in bankruptcy. *See, e.g.*, *In re* Expert S. Tulsa, LLC, 456 B.R. 84, 87 (Bankr. D. Kan. 2011) (stating "[e]scrow agreements are not executory contracts"); *In re* TTS, Inc., 158 B.R. 583, 588–89 (D. Del. 1993) (holding that escrow agreement was not an executory contract because one of the parties had fulfilled its obligations by depositing funds into escrow account). Moreover, if the escrow agreement is found to be an executory contract, the purported escrow agreement would likely fail as an appellate security, in any event.

tailor the terms of the agreement, but the lack of uniformity in terms of establishing an enforceable escrow may also be the arrangement's biggest drawback.

1. Property of the Bankruptcy Estate

If an appellee agrees to an escrow as an appellate security and the appellant files for bankruptcy protection (or is subject to an involuntary proceeding), the escrow agreement and the debtor's interest in the escrow account are analyzed under the law of the state where the escrow is formed, presumably where the appeal is pending.[57] If structured properly under that state's laws, the escrow should be analogous to a supersedeas bond. The estate's interest is limited to the debtor's contingent right to the escrowed property if the specified conditions are met, similarly to how the estate's interest in a supersedeas bond is limited to the debtor's reversionary interest subject to divestment.[58]

The judgment creditor's first consideration must be to ensure that the escrow agreement does in fact create an enforceable escrow under state law.[59] Failure to

[57] *See In re* Atl. Gulf Cmtys. Corp., 369 B.R. 156, 162 (Bankr. D. Del. 2007) (looking to New York law to determine debtor's right to an escrow account formed in New York); *In re TTS*, 158 B.R. at 586 ("As the escrow agreement was entered into in New York, this Court should apply New York law to determine each party's interests in the escrow account."); *In re* BNT Terminals, Inc., 125 B.R. 963, 969 (Bankr. N.D. Ill. 1990) (stating "[t]he present issue involves a transfer consummated in the state of Illinois. Therefore, the court must look to Illinois law to determine whether the escrow somehow operated to divest . . . [the debtor] of any interest in the funds deposited into the escrow").

[58] *See In re Expert S. Tulsa*, 456 B.R. at 88 ("While the estate received Debtor's contingent remainder interest under the escrow agreement, such interest cannot vest until the [conditions are satisfied] . . . . As of the petition date, Debtor had no vested interest in the escrow funds, and the funds are not property of the estate."); *see also In re Atl. Gulf*, 369 B.R. at 164–65 (concluding under New York law "that the Escrow is not property of the estate, even though the contingent interest that the Debtor has in the Escrow is property of the estate"); *In re* Holmes Envtl., Inc., 287 B.R. 363, 382 (Bankr. E.D. Va. 2002) ("When an escrow or trust is created, the only interest left in the escrowed funds is a contingent right to any surplus after payment of the claims against the fund."); *In re* Royal Bus. Sch. Inc., 157 B.R. 932, 940 (Bankr. E.D.N.Y. 1993) ("[W]hen considering preference actions, the predominant rule is that a subsequent judgment or release of escrow monies does not deprive the estate of anything of value since the debtor reserves only a contingent right to the escrowed funds."); *In re* Cedar Rapids Meats, Inc., 121 B.R. 562, 568 (Bankr. N.D. Iowa 1990) ("[O]nce the escrow was created the *only* interest in the escrow funds remaining in the debtor was a contingent right to the funds . . . ") (quoting *In re* Newcomb, 744 F.2d 621, 627 (8th Cir. 1984)); *In* re O.P.M. Leasing Servs., Inc., 46 B.R. 661, 668 (Bankr. S.D.N.Y. 1985) (holding debtor "retained only a contingent right to the funds [in escrow] which was of no value to the estate"); *In re* Palm Beach Heights Dev. & Sales Corp., 52 B.R. 181, 183 (Bankr. S.D. Fla. 1985) ("Any claim, contingency or chose in action against the trust fund is the property of the estate but the fund itself is not.").

[59] For instance, under New York law:

> An escrow is a written agreement that imports a legal obligation to deposit an instrument or property by the promisor with a third party to be kept by the latter in

create a "true" escrow could be disastrous. In *Affiliated Computer Systems, Inc. v. Sherman (In re Kemp)*,[60] for instance, the court found that "there was no true escrow agreement" under Texas law, and thus the allegedly escrowed funds became property of the bankruptcy estate that had to be turned over to the bankruptcy trustee.[61] As the court explained, all of the cases in which bankruptcy courts have found escrow accounts to be outside the estate "involved true escrow accounts that were created by bona fide, legally valid escrow agreements. In determining whether the funds in question were property of the debtors' estates, the bankruptcy courts in those cases looked to the nature and circumstances of the underlying escrow agreements."[62]

Assuming that the escrow is properly formed under applicable state law, an unfavorable ruling by the appellate court should strip the appellant of any interest in the escrow and prevent the escrowed property from becoming property of the bankruptcy estate. In *In re Keene Corporation*,[63] applying New York escrow law, the court reached this precise result, finding that the debtor-appellant "was divested of legal title in escrows securing judgments that became final prior to the filing of the petition. Divested of legal title, it had no further interest—legal or equitable—in the escrows, and hence, these escrows are not property of the estate."[64]

> the capacity of depository or escrowee until the performance of a condition or happening of an event, which then is to be delivered by escrow agent to the promisee.

In re Atlantic Gulf, 369 B.R. at 162 n.5 (quoting Nat'l Union Fire Ins. Co. v. Proskauer Rose Goetz & Mendelsohn, 634 N.Y.S.2d 609, 614 (Sup. Ct. 1994)). "Moreover, in order for an escrow to be valid, the transfer [to the escrow agent] must be irrevocable" and "the property must be beyond the possession and control of the grantor while it is in the hands of the escrow agent." *In re Royal Bus.*, 157 B.R. at 940. A complete survey of escrow law in the various states is beyond the scope of this Article. Escrows formed under New York law appear to be some of the most frequently encountered in bankruptcy courts, and bankruptcy courts have generally ruled consistently and favorably with respect to such escrows. *See supra* note 58. Hence, if possible, the judgment creditor may wish to insert a choice of law provision in favor of New York (or other favorable jurisdiction). Although not certain, such a provision may be enforceable. *See In re* ANR Advanced Transp. Co., Inc., 247 B.R. 771, 774 (Bankr. E.D. Wis. 2000) (enforcing Colorado choice of law provision in escrow agreement).

[60] 52 F.3d 546 (5th Cir. 1995).

[61] *Id.* at 551, 554. If escrowed property is found to belong to the bankruptcy estate, the escrow agent must turn the property over to the trustee (or debtor in possession in a chapter 11 proceeding). *See* 11 U.S.C. § 542(a) (discussing of turnover of property to estate); *see also* 11 U.S.C § 1107(a) (providing debtor in possession has rights and powers of a chapter 7 trustee).

[62] *In re Kemp*, 52 F.3d at 550–51.

[63] 162 B.R 935 (Bankr. S.D.N.Y. 1994).

[64] *Id.* at 943; c*f. In re* Jazzland, Inc., 322 B.R. 610, 617 (E.D. La. 2005) (finding escrow conditions were fulfilled pre-petition and thus "funds did not form part of the bankruptcy estate"); *In re* 100 Lindbergh Blvd. Corp., 128 B.R. 53, 57 (Bankr. E.D.N.Y. 1991). The *Lindbergh* court stated that the escrow funds:

As with supersedeas bonds, the result *should* be the same if the contingency is resolved post-petition through resolution of the appeal after relief from stay. In *Musso v. New York State Higher Education Services Corporation (In re Royal Business School, Inc.)*,[65] also decided with reference to New York escrow law, an agreement executed by the debtor pre-petition called for the debtor to deposit certain sums into an escrow account which were to be paid in satisfaction of an administrative ruling if the debtor unsuccessfully exhausted its judicial remedies.[66] The debtor challenged the ruling, but filed a bankruptcy petition before the decision upholding the administrative ruling was issued.[67] The court nonetheless found that the debtor's contingent interest in the escrow account on the petition date was terminated by the post-petition unfavorable appellate ruling.[68]

Unfortunately, courts have not always ruled clearly and consistently, which may make an escrow arrangement somewhat riskier for the appellant in bankruptcy than a supersedeas bond, even in the case of a true escrow.[69] For instance, in *Wilson v. United Savings of Texas (In re Missionary Baptist Foundation of America, Inc.)*,[70] the court simply held that *when the contingency necessary for the debtor to recover escrowed funds is completed pre-petition*, the funds in escrow become property of the estate.[71] In other words, the escrow in *Missionary Baptist* had effectively terminated pre-petition.

Yet, the court in *In re Berkley Multi-Units, Inc.*,[72] finding itself bound by *Missionary Baptist*, held that funds placed into escrow by the debtor remain the debtor's property and become estate property *unless the contingency of the*

> [W]ere properly released from escrow over five months before the petition for relief was filed. Therefore as of the date of the filing of the petition for relief, the estate did not possess an interest in that property by virtue of the fact that the money was once held in an escrow account.

Id.

[65] 157 B.R. 932 (Bankr. E.D.N.Y. 1993).

[66] *Id.* at 936.

[67] *Id.*

[68] *Id.* at 942. *But cf. In re* Anthony Sicari, Inc., 144 B.R. 656, 662 (Bankr. S.D.N.Y. 1992) (cautioning in dictum that if "release of escrowed funds occurs post-petition, a different outcome may result").

[69] *Cf.* Thomas M. Byrne, *Escrows and Bankruptcy*, 48 BUS. LAW. 761, 776–77 (1993) ("[E]nough uncertainty exists in the case law to recommend caution in using escrows in transactions where insolvency risks are present.").

[70] 792 F.2d 502 (5th Cir. 1986).

[71] *See id*. at 506 ("Where the contingency of the escrow was not fulfilled prior to bankruptcy, the debtor holds an interest in the property.") (citing *In re* Flannery, 51 B.R. 697 (Bankr. S.D. Ohio 1985)).

[72] 69 B.R. 638 (Bankr. M.D. Fla. 1987).

escrow was fulfilled pre-petition.[73] However, this holding is *not* required by *Missionary Baptist*. The *Berkley* court seizes on the following statement from *Missionary Baptist*: "Where the contingency of the escrow was not fulfilled prior to bankruptcy, the debtor holds *an interest* in the property."[74] Given the holding of *Missouri Baptist*, the statement is dictum,[75] and it says nothing about the nature or extent of the retained interest. In fact, the case cited within *Missionary Baptist* for this proposition, *In re Flannery*,[76] likewise fails to identify or explain the nature of the debtors' interest, concluding only that the debtors held "a legal or equitable interest" in the escrowed property.[77] The continuing validity of *Berkley*, however, is questionable in light of the Eleventh Circuit's opinion in *Dzikowski v. NASD Regulation, Inc. (In re Scanlon)*,[78] which held that "funds that are deposited into an escrow account by a debtor, for the benefit of others, cannot be characterized as property of the estate."[79]

Some courts have applied a middle-ground approach, in which the court examines the particular facts and circumstances of the transaction at issue. As one court explained:

> Escrow accounts are . . . difficult to diagnose. Factors that are relevant, although not necessarily determinative, include whether the debtor initiated and/or agreed to the creation of the escrow, what if any control the debtor exercises over it, the incipient source of it, the nature of the funds put into it, the recipient of its remainder (if any), the target of its benefits, and the purpose for its creation. In short, whether an escrow constitutes property of a debtor's estate depends entirely on the nature and circumstances of the escrow in question.[80]

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[73] *See id*. at 641–42 (considering, among other things, whether transfer was pre- or post-petition).

[74] *In re Berkley*, 69 B.R. at 641 (emphasis added) (quoting *In re Missionary Baptist,* 792 F.2d at 506) (citation omitted).

[75] *In re Missionary Baptist*, 792 F.2d at 506 (holding that no contingency interest existed at date of bankruptcy).

[76] 51 B.R. 697 (Bankr. S.D. Ohio 1985).

[77] *Id.* at 700.

[78] 239 F.3d 1195 (11th Cir. 2001).

[79] *Id.* at 1198 (applying Florida escrow law) (internal quotations marks omitted) (citation omitted); *see also* 5 COLLIER ON BANKRUPTCY ¶ 541.09 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009) (noting"[i]n general, most courts have held that assets in escrow are not property of the estate," and distinguishing cases holding otherwise). *But see* Byrne, *supra* note 69, at 773 (noting inconsistency in case law regarding treatment of escrows in bankruptcy).

[80] *In re* World Commc'ns, Inc., 72 B.R. 498, 500–01 (D. Utah 1987); *see In re* Cedar Rapids Meats, Inc., 121 B.R. 562, 567 (Bankr. N.D. Iowa 1990); *In re* Mona Lisa at Celebration, Inc., 472 B.R. 582, 646 (Bankr. M.D. Fla. 2012), *aff'd*, 495 B.R. 535 (M.D. Fla. 2013) ("Whether the deposits become

2. Preferential and Fraudulent Transfer Liability

An escrow's potential exposure to an avoidance action is likely to be substantially the same as that of supersedeas bonds. Importantly, the date of the transfer is the date when the funds are deposited into the escrow account, not the date when the funds are withdrawn by the grantee.[81] Hence, given the usual length of the appellate process, preference exposure is minimal.

Aside from potential cost savings, an advantage of using an escrow in lieu of a supersedeas bond may be the ability to control the source of the funds to prevent the possibility, discussed above in Part II.B., that the funds originate from an affiliate of the judgment debtor and are recoverable as a fraudulent transfer in a bankruptcy involving the affiliate, based on a lack of reasonably equivalent value to that entity. The appellee considering an escrow arrangement should require, as a condition to consenting to the alternative appellate security, assurances as to the source of the escrowed property and the solvency of that entity both before and after the deposit, including an opinion of counsel as to the non-avoidability of the transfers of the appellant's property into and out of the escrow.

B. Standby Letters of Credit

A third option as an appellate security is the standby letter of credit ("LOC"). The LOC is a guarantee of payment by a third-party issuer, typically a bank, upon presentation of proof by the beneficiary that specified conditions have occurred.[82] To be used as an appellate security, the conditions for payment would be a favorable ruling for the appellee and the appellant's failure to pay.

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property of the estate depends on the nature of the escrow agreement.") (citing *In re Cedar Rapids*, 121 B.R. at 567).

[81] Carlson v. Farmers Home Admin. (*In re* Newcomb), 744 F.2d 621, 626–27 (8th Cir. 1984) ("Given the unavoidable transfer that occurred when the escrow was created, the transfer that occurred when the condition of the escrow was met is not the type of transfer that can be avoided."); *In re* Anthony Sicari, Inc., 144 B.R. 656, 661 (Bankr. S.D.N.Y. 1992).

> The courts have uniformly held that the transfer of funds into escrow occurs at the time the debtor deposits the funds into the escrow account . . . . Neither the date the funds are released to the grantee nor the date the funds revert back to the grantor for failure of conditions precedent, is relevant under Code § 547(b).

Id. (internal quotations omitted); *In re* Coco, 67 B.R. 365, 369 (Bankr. S.D.N.Y. 1986) ("[T]he escrow cases are uniform in holding that it is the debtor's *deposit* of funds into escrow and not the award of judgment or subsequent release of the funds that is the controlling transfer for preference purposes.") (emphasis in original) (citations omitted).

[82] *See* Douglas Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130, 130 (1982).

The applicant—here, the appellant—pays a fee to the issuing bank and posts collateral.[83] By inserting an independent third party as the payor, the LOC arrangement insulates the beneficiary—here, the appellee—from the appellant's bankruptcy estate.

Draws on an LOC are consistently held to be unassailable in a bankruptcy filing by or on behalf of the party whose assets secure the LOC.[84] Assuming the same set of facts, an LOC should be at least as effective as a supersedeas bond or escrow and largely eliminates any uncertainty from inconsistent decisions and sparse case law. LOCs are standardized, regulated[85] commercial instruments that are widely used in the domestic and international banking industry, eliminating the need for assistance from local counsel to adhere to unique state escrow laws.[86] Although a few unique considerations need to be taken into account, the primary risk associated with the LOC should be the same limited exposure to avoidance as an indirect transfer that is implicated by supersedeas bonds and escrows. Moreover, use of an LOC in lieu of a supersedeas bond is not unprecedented, and obtaining court approval for the arrangement should be relatively straightforward.[87]

There are, however, certain issues unique to LOCs that must be addressed. Most significantly, LOCs are issued for limited terms, typically one year.[88] Hence, to ensure that the security lasts for the duration of the appeal, the LOC should include an evergreen clause that requires automatic renewal. The parties must also consider what will happen if the issuing bank declines to renew the LOC. If that occurs, the LOC should require that the bank give sufficient notice to allow the appellant to secure a replacement LOC or should require that the

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[83] The fee is likely to be less than the premium required to obtain a supersedeas bond. Moreover, bonding companies often require an LOC to be posted as security for the bond. Thus, using an LOC as the appellate security itself eliminates a second layer of fees.

[84] *See infra* note 89 and accompanying text.

[85] *See, e.g.*, 12 C.F.R. § 7.1016 (2013) (regulating LOCs issued by national banks); U.C.C. § 5-101–118 (2011-2012) (regulating LOCs); Int'l Standby Pracs. (ISP98) (regulating international use of LOCs).

[86] *See* Cassondra E. Joseph, *Letters of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816, 816, 819 (documenting widespread international and domestic use of LOCs).

[87] *See* Ligurotis v. Whyte, 951 F.2d 818, 821 (7th Cir. 1992) ("Along with the Second Circuit, . . . we have noted that a letter of credit may serve as the equivalent of a supersedeas bond.") (citations omitted); *see also* Bishop v. Mid-Am. Auto Auction, Inc., No. 89-2029, 1993 WL 169116, at *1 (D. Kan. Apr. 26, 1993) ("Finding the defendants' arguments for approval of the letters of credit persuasive, the court will allow such security."); Home Mut. Fire Ins. Co. v. Jones, 62 Ark. App. 182, 185 (1998) ("Inasmuch as the issuer of a letter of credit makes 'a definite undertaking' to a beneficiary to honor a documentary presentation payment or delivery of an item of value, we see no reason why a letter of credit cannot constitute an acceptable surety for purposes of a supersedeas bond.").

[88] WILLIAM L. NORTON III & ROGER G. JONES, NORTON CREDITORS' RIGHTS HANDBOOK § 2:14 (2012) (stating"[t]ypically, a letter of credit expires no later than one year from the date of issue").

bank pay the proceeds of the LOC into a neutral account, such as a court registry.

1. Property of the Bankruptcy Estate

It is a "well-established rule of bankruptcy law that a letter of credit and the proceeds therefrom are not property of the debtor's estate."[89] Pursuant to the "independence principle that underlies letter of credit law," LOCs consist of separate and independent obligations.[90] Thus, the issuer of the LOC must honor its obligation to pay the beneficiary irrespective of the issuer's ability to collect from the debtor. As one court explained:

> [L]etters of credit really are different from other financing mechanisms . . . . [I]ndependent obligations [ran] . . . from the bank to the beneficiaries. From the point of view of the beneficiaries, . . . the way that [the bank] settled its accounts with [the debtor] was of no importance, either legal or practical. As soon as [the bank] issued the irrevocable letters in favor of each beneficiary . . . , it assumed the obligation of paying upon a draft supported by documents that conformed to the terms of the credit. Thus, when [the beneficiary] presented its draft with conforming documents to [the bank] . . ., [the bank] was required to pay [the beneficiary] the full [amount] that the letter of credit then provided, whether or not [the debtor] gave it a red

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[89] Int'l Fin. Corp. v. Kaiser Grp. Int'l Inc. (*In re* Kaiser Group International Inc.), 399 F.3d 558, 566 (3d Cir. 2005) (internal quotations and citations omitted); *see In re* Duplitronics, Inc., 183 B.R. 1010, 1015 (Bankr. N.D. Ill. 1995) ("Because a bank's obligation on a letter of credit is independent of the transaction between the beneficiary and the bank's customer, it is settled law that the letter of credit is not property of the estate and that the § 362 automatic stay is inapplicable."); 5 COLLIER ON BANKRUPTCY, *supra* note 79, at ¶ 541.08 ("Funds from which a bank must honor a letter of credit are its property and do not constitute property of the debtor.").

[90] P.A. Bergner & Co. v. Bank One, Milwaukee, N.A. (*In re* P.A. Bergner & Co.), 140 F.3d 1111, 1118–19 (7th Cir. 1998). In fact, the independence of LOC obligations is mandated by law. *See* U.C.C. § 5-103(d) (2001).

> Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

Id. See also 12 C.F.R. § 7.1016(b)(1)(i) ("The independent character of the undertaking should be apparent from its terms (such as terms that subject it to laws or rules providing for its independent character).").

> cent. If [the debtor] did not comply with its own agreement with [the bank] . . ., then [the bank] would have had a perfectly good contract action against [the debtor], but it would have had no defense against honoring the beneficiary's demand.[91]

2. Preferential and Fraudulent Transfer Liability

Because the proceeds of the LOC are not property of the estate, they cannot be recovered as preferential or fraudulent transfers.[92] Similar to the other appellate securities, however, there is the potential for avoidance of an indirect transfer to the beneficiary of the LOC as a result of the debtor's pledge of collateral to the issuer.[93] Again, exposure to avoidance as a preferential transfer is minimized by the fact that the transfer occurs when the collateral is pledged, not when the proceeds are distributed.[94] Also, fraudulent transfer liability is minimal because the debtor will generally be viewed as receiving reasonably equivalent value.[95] As in the escrow context, the ability to withhold consent to the LOC as a lower cost alternative security may grant the appellee some leverage to receive appropriate assurances as to the source of the payment and collateral.[96]

IV. CAUTION

As a word of caution, even the most secure appellate security—one that is not property of the judgment debtor's bankruptcy estate and not avoidable as a preferential or fraudulent transfer—could still be thwarted if the bankruptcy court finds a compelling reason to do so. In particular, bankruptcy courts have the power to issue injunctions under section 105(a) of the Bankruptcy Code,[97] and bankruptcy courts have occasionally used this power to enjoin collection

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[91] *P.A. Bergner*, 140 F.3d at 1119.

[92] *See* 5 COLLIER ON BANKRUPTCY, *supra* note 79, at ¶ 547.03 (explaining "payments by the issuer of a letter of credit cannot be recovered as a preference because they are not transfers of the debtor's property."); Kupetz v. Continental Ill. Nat'l Bank & Trust Co. of Chicago, 77 B.R. 754, 764 (C.D. Cal. 1987), *aff'd sub nom.,* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988) (holding payment on letter of credit is not a transfer of property of the debtor and thus not recoverable as a fraudulent transfer).

[93] *See In re* Compton Corp., 831 F.2d 586, 591–92 (5th Cir. 1987) ("[I]ndirect transfer . . . may constitute a voidable preference as to the [LOC's beneficiary] who indirectly benefitted from the direct transfer to the third party"); *accord In re* Air Conditioning, Inc., 845 F.2d 293, 296 (11th Cir. 1988).

[94] *In re Compton Corp.*, 831 F.2d at 595; *In re Air Conditioning, Inc.,* 845 F.2d at 296.

[95] *See supra* note 24 and accompanying text.

[96] *See supra* Part III.A.2.

[97] 11 U.S.C. § 105(a) (2012) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

from appellate securities when necessary for the debtor to effectively reorganize under chapter 11.[98]

In *Celotex*,[99] the court used its powers under section 105(a) to enjoin judgment creditors from executing on supersedeas bonds, even after resolution of the appeal.[100] The bankruptcy court's power to issue such an injunction has been called into question.[101] Moreover, the court emphasized the unique circumstances in that case, which involved the reorganization of a debtor who was involved in over 141,000 pending asbestos-related cases and over 100 such cases on appeal.[102]

In *In re Alwan Brothers Co., Inc.*,[103] the chapter 11 debtors, who included individuals, had entered into a "Supersedeas Bond Trust Agreement," whereby they pledged certain real estate to a trustee to stay enforcement of a judgment pending appeal.[104] Although the court did not refer to the arrangement as an escrow, it appears that it would likely have qualified as such.[105]

The debtors lost the appeal but filed for bankruptcy protection before the property was transferred.[106] Finding the trust agreement to be the equivalent of a supersedeas bond, the court followed the decisions finding that a supersedeas

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[98] *In re* Celotex Corp., 128 B.R. 478, 485 (Bankr. M.D. Fla. 1991) ("Where at the time of filing the petition, the appellate process between Debtor and the judgment creditor had been concluded, the judgment creditor is precluded from proceeding against any supersedeas bond posted by Debtor without first seeking to vacate the Section 105 stay entered by this Court.").

[99] 128 B.R. 478 (Bankr. M.D. Fla. 1991).

[100] *Id.* at 484 ("Where this Court has granted relief from the stay to complete the appellate proceedings involving Debtor and the appellate process has concluded in favor of the judgment creditor, that judgment creditor is precluded from proceeding against any supersedeas bond without first seeking to vacate the Section 105 stay in this Court.").

[101] *See* Edwards v. Armstrong, 6 F.3d 312, 320 (5th Cir. 1993) *rev'd sub nom*. Celotex Corp. v. Edwards, 514 U.S. 300 (1995).

> Whatever the ultimate scope of section 105, it does not extend so far as to give the bankruptcy court authority over a supersedeas bond in which the debtor has no interest. Because the appeal has terminated and mandate issued, the surety's liability on the bond matured and the judgment creditors should be allowed to collect.

Id. But see Willis v. Celotex Corp., 978 F.2d 146, 149–50 (4th Cir. 1992) (finding same injunction to be valid). The Supreme Court reversed the Fifth Circuit's ruling as an improper collateral attack of the bankruptcy court's order but declined to rule whether the injunction was proper in the first instance. *See Edwards*, 514 U.S. at 312–13.

[102] *See In re Celotex*, 128 B.R. at 482.

[103] 105 B.R. 886 (Bankr. C.D. Ill. 1989).

[104] *Id.* at 886–87.

[105] *See In re* Keene, 162 B.R. 935, 949 (Bankr. S.D.N.Y. 1994) (acknowledging "the trust agreement in *Alwan* is similar to the escrow agreements at issue").

[106] *In re Alwan Brothers*, 105 B.R. at 887.

bond is not property of the bankruptcy estate.[107] But the court described the case as "unprecedented" because, although the judgment was based on debts that were nondischargeable under section 523(a),[108] a large portion of the judgment consisted of punitive damages, which the court held to be dischargeable as to the individual chapter 11 debtors.[109] The court found that this fact "necessitate[d] a change in the terms of the [trust agreement]" and allowed the judgment creditor to proceed against only so much of the real estate necessary to satisfy the nondischargeable compensatory portion of the damages award.[110] The court stated that the "remaining property shall *revest* in the [debtors] and shall be subject to the jurisdiction of this Court."[111]

The *Alwan* court did not rely on section 105(a). Rather, the court appeared to rest on the "fresh start" policy for individuals in bankruptcy to prevent the debtors from losing property on account of discharged debts.[112] But the court failed to reconcile the fact that the property was already not part of the bankruptcy estate. As one court noted, the *Alwan* opinion is "logically inconsistent" and has not been followed by other courts.[113] But, similar to the *Celotex* decision, it remains as an example of the unpredictability of bankruptcy courts and the lengths to which bankruptcy judges may go in order to fulfill their perceived mandate of facilitating fresh starts and successful reorganizations.[114]

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[107] *Id.* at 895 (citing Mid-Jersey National Bank v. Fidelity-Mortgage Investors, 518 F.2d 640 (3d Cir. 1975)).

[108] *See* 11 U.S.C. § 523(a)(2), (4), (6) (2012).

[109] *In re Alwan Brothers*, 105 B.R. at 895.

[110] *Id.*

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

[112] *See id.* at 891 (discussing fresh start policy).

[113] *In re* Keene Corp., 162 B.R. 935, 948–49 (Bankr. S.D.N.Y. 1994) (declining to follow "the *Alwan* reasoning because it is logically inconsistent and contravened by case law in this district").

[114] Although not in the context of an appellate security, the opinion in *Wysko Investment Co. v. Great American Bank*, 131 B.R. 146 (D. Ariz. 1991), is another reminder of how unpredictable bankruptcy courts, and even district courts, can be. In *Wysko*, the district court, in a short opinion, upheld the bankruptcy court's issuance of an injunction against drawing on a letter of credit on the basis that it would impair the debtor's ability to reorganize. *Id*. at 148 ("The fact that the injunction was necessary for reorganization is an unusual circumstance which justifies the use of the Bankruptcy Court's Section 105 powers to enjoin a letter of credit."). Fortunately for the financial industry, which relies upon the independence of the letter of credit obligations, the *Wysko* decision has not been cited, favorably or unfavorably, by a single reported case, and there do not appear to be any other decisions supporting such an injunction. Rather, *Wysko* has been seemingly ignored by the courts and has been criticized by commentators as "ill-considered." 5 COLLIER ON BANKRUPTCY, *supra* note 79, at ¶ 105.04[2][a] n.57.

CONCLUSION

An alternative appellate security, such as an escrow arrangement or a standby letter of credit, may be an economical alternative to a traditional supersedeas bond. When considering whether to consent to such an arrangement, an appellee should be cognizant of the impact that a bankruptcy filing involving the appellant, or possibly one of its affiliates, would have on the ability to enforce the security. Reported decisions suggest that escrows and letters of credit offer a similar level of security as supersedeas bonds. And the ability to control the source of the payment and collateral for the alternate security may be advantageous for reducing exposure to preferential and fraudulent transfer avoidance. Given its increased uniformity and consistency of treatment by the courts, the standby letter of credit is likely the safer option. But regardless of whether the appellate security is a supersedeas bond, an escrow, a letter of credit, or anything else, judgment creditors must remember that there is no sure thing in bankruptcy court.