UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
HECHINGER INVESTMENT COMPANY OF DELAWARE, INC., et al.,	)	Case No. 99-2261 (PJW)
	)	
	)	(Jointly Administered)
Debtors.	)	

MEMORANDUM OPINION

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Date: January 29, 2001

WALSH, J.

Before the Court is the motion (Doc. # 1020) of Newcourt Leasing Corporation ("Newcourt") to compel payment of postpetition rent by chapter 11 debtor Hechinger Investment Co. of Delaware, Inc. ("Hechinger") under 11 U.S.C. § 365(d)(10)[1] or alternatively, for adequate protection. At issue is Newcourt's allocation of proceeds from a letter of credit Hechinger posted to secure its performance under an equipment lease. For the reasons discussed below, I will deny Newcourt's motion.

BACKGROUND

The parties do not dispute most of the relevant facts. On September 24, 1998, Hechinger and Sun Data, Inc. entered into a Master Lease agreement, including a Master Lease Schedule No. 246156 (together, the "Lease") in which Sun Data, Inc. leased computer related equipment (the "Equipment") to Hechinger. Sun Data, Inc. assigned the Lease to A.T.& T. Capital Leasing Service, Inc., which subsequently changed its name to Newcourt Leasing Corporation.[2]

The Lease required Hechinger to make monthly payments of

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1 Unless otherwise indicated, all references to "§___" are to a section of the Bankruptcy Code, 11 U.S.C. § 101 et. seq.

2 Although the Lease refers to the lessor as Sun Data, Inc., in light of the assignment and subsequent name change, I will hereinafter refer to the lessor as Newcourt.

$33,380.00 for an initial term of 36 months. Hechinger posted a $600,000 standby letter of credit ("Letter of Credit") in favor of Newcourt, issued by Bank Boston, to secure Hechinger's performance under the Lease. The Letter of Credit required Bank Boston to pay Newcourt up to $600,000 upon Newcourt's representation that Hechinger was in default under the Lease.

On June 11, 1999, Hechinger and its affiliates filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code ("Petition Date"). Hechinger was current on its obligations under the Lease at that time. It continued to use the Equipment postpetition but inadvertently failed to make postpetition rent payments, an oversight it blames on an internal clerical error.

On September 29, 1999, Newcourt drew on the Letter of Credit in the full amount of $600,000 ("LOC Proceeds") after representing to Bank Boston that Hechinger was in default. According to Newcourt, it simultaneously accelerated the Lease and applied the LOC Proceeds to the present value of its resultant claim for damages of $706,163.34 ("Lease Damages Claim").

The parties dispute the details of Newcourt's draw. Hechinger claims Newcourt did not give any notice of default or intent to accelerate. Hechinger states it first became aware of overdue rent on September 23, 1999, the day Bank Boston informed Hechinger that Newcourt intended to draw on the Letter of Credit. The Debtor claims the only communication it received from Newcourt was a notice of default letter dated October 1, 1999.

Newcourt, on the other hand, states it sent Hechinger a letter of nonpayment on August 1, 1999. It claims it sent the October letter to Hechinger in error because of an oversight in not placing a code on Hechinger's account to prevent letters from being sent during a pending bankruptcy case.

On October 27, 1999, Newcourt filed the present motion in which it asserts two claims, as modified by its supplemental brief (Doc. # 2266).[3] First, Newcourt asserts a claim of $106,163.34 which it states is the balance due on the $706,163.64 Lease Damages Claim after application of the $600,000 LOC Proceeds. Second, it asserts an administrative expense claim of $220,641.74 for Hechinger's postpetition use of the Equipment ("Postpetition Rent Claim").

Hechinger rejected the Lease effective January 14, 2000.[4] It does not dispute that Newcourt had an administrative expense claim for postpetition rent. It also agrees that Newcourt has a claim for Lease rejection damages, although Hechinger disputes the

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3 In the same motion, Newcourt also requested adequate protection payments as an alternative to postpetition rent payments. The parties agree this portion of Newcourt's motion is moot in light of Hechinger's rejection of the Lease and return of the Equipment.

4 See Motion of the Debtors Pursuant to Section 365 of the Bankruptcy Code and Bankruptcy Rule 6006 for Approval of the Rejection of a Certain Equipment Lease by and Between the Debtors and Newcourt Leasing Corporation (Doc. # 1664) and signed Order (Doc. # 2074).

exact amount. Hechinger insists, however, that the LOC Proceeds paid Newcourt's Postpetition Rent Claim in full, leaving Newcourt with only a general unsecured claim for the balance due on the Lease Damages Claim.

I held a hearing on May 4, 2000 at which I directed the parties to submit supplemental briefs on Newcourt's right to payment of postpetition rent in light of its draw on the Letter of Credit.[5] The parties filed their supplemental briefs and I took the matter under advisement.

DISCUSSION

As a threshold matter, I turn to Newcourt's argument that Hechinger lacks standing to challenge Newcourt's application of the LOC Proceeds because the Letter of Credit is not property of Hechinger's bankruptcy estate. I reject this argument. The fact that Newcourt received payment from a letter of credit does not immunize Newcourt from a challenge by Hechinger as to the propriety of that payment under the Lease. Neither the "doctrine of independence" nor the cases which Newcourt cites dictate otherwise.

As explained by the Court of Appeals for the Third

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5 I declined to rule on the amount of Newcourt's lease rejection damages at the hearing. Hechinger challenged Newcourt's calculations based in part on Hechinger's return of the Equipment. I likewise do not rule on the issue at this time. Any reference herein to the amount of Newcourt's Lease Damages Claim is for sake of argument only and is not an evidentiary ruling as to the allowable amount of the claim.

Circuit:

> Ordinarily there are three distinct agreements in a letter of credit transaction: the underlying contract between the customer and the beneficiary which gave rise to their resort to the letter of credit mechanism to arrange payment; the contract between the bank and its customer regarding the issuance of the letter and reimbursement of the bank upon its honoring a demand for payment; and the letter of credit itself, obligating the bank to pay the beneficiary.
>
> Since the letter of credit is completely independent from the other contracts, . . . the extent of the bank's undertaking is set forth solely in the letter. Generally, the bank . . . need not monitor the underlying contract. Rather, it has only to determine whether the documents presented appear on their face to be in accordance with the terms and conditions of the letter of credit, and its responsibility in this regard is entirely ministerial. In fact, the issuer of the letter must pay the beneficiary regardless of whether the underlying contract has been performed, except when there has been fraud or some other irregularity, or an undertaking to the contrary.
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> Ins. Co. of North Am. v. Heritage Bank, N.A., 595 F.2d 171, 173-74 (3d Cir. 1979); accord Demczyk v. Mut. Life Ins. Co. of New York (In re Graham Square, Inc.), 126 F.3d 823, 827 (6th Cir. 1997); CCF, Inc. v. First Nat'l Bank & Trust Co. of Okmulgee (In re Slamans), 69 F.3d 468, 474 (10th Cir. 1995).

In the present controversy, the initial contract giving rise to the Letter of Credit is the Lease between Hechinger and Newcourt. The second contract is the agreement between Hechinger, the account party, and Bank Boston, the issuing bank. The third contract is the letter of credit itself, the agreement between Bank

Boston and Newcourt, the beneficiary.

A letter of credit is designed to function as a swift and certain payment mechanism.[6] Once a beneficiary complies with the terms of the letter of credit, an account party may generally not prevent the issuing bank from distributing proceeds. In re Graham Square, Inc., 126 F.3d at 827; Heritage Bank, 595 F.2d at 173. Courts call this the "independence principle" because of the independence of the letter of credit from the underlying commercial transaction. In re Slamans, 69 F.3d at 474.

It is this principle on which Newcourt relies for its argument that Hechinger lacks standing to challenge the distribution of the LOC Proceeds. Newcourt asserts the majority judicial view that neither a letter of credit nor its proceeds are property of a debtor's bankruptcy estate given the independent nature of the letter of credit agreement and the fact that its proceeds are funds of the issuer, not of the debtor. Guy C. Long, Inc. v. Dependable Ins. Co. (In re Guy C. Long, Inc.), 74 B.R. 939, 943-44 (Bankr. E.D. Pa. 1987)(collecting cases).

While I agree that the doctrine of independence may have

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6 A standby letter of credit deviates somewhat from the traditional function of the letter of credit as a payment device in a purchase and sale transaction. A standby letter of credit is typically used in a nonsales transaction as a guarantee against default on contractual obligations. In re Graham Square, Inc., 126 F.3d at 827 citing Gerald T. McLaughlin, Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy, 43 OHIO. ST. L.J. 1, 6 (1982).

prevented Hechinger from enjoining the distribution of the LOC Proceeds, an issue I need not resolve given Newcourt's unimpeded draw, I do not agree that it likewise prohibits Hechinger from asserting its rights under the Lease. It seems to me that Newcourt is raising its defense under the Letter of Credit, i.e., its contract with Bank Boston, as a defense to Hechinger's challenge under the Lease, i.e., its contract with Hechinger. The doctrine of independence applies to the former, but not to the latter. Newcourt's application of the LOC Proceeds to the Lease Damages Claim does not prevent Hechinger from asserting that Newcourt had no such claim under the Lease itself. Accord In re Graham Square, Inc., 126 F.3d at 828 ("[C]hallenging the distribution of the proceeds of a letter of credit is different than challenging the underlying contract. The ultimate result may be the same (refund of the fee), but in one case the method of recovery is permissible and in the other it is barred").

The present controversy is factually distinguishable from the cases Newcourt cites. See Supplemental Response of Newcourt Leasing Corporation in Support of Motion to Compel Payments Required Under 11 U.S.C. § 365(d)(10) ("Newcourt's Supplemental Response")(Doc. # 2361) at p. 6, ¶ 15, citing Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 589 (5th Cir. 1987); Grove Peacock Plaza, Ltd. v. Resol. Trust Corp. (In re Grove Peacock Plaza, Ltd.), 142 B.R. 506, 519 (Bankr. S.D. Fla. 1992); In re M.J. Sales & Distrib. Co., Inc., 25 B.R. 608 (Bankr. S.D.N.Y.

1982). These cases involved an attempt to enjoin distribution under a letter of credit or to recover such distribution as a voidable preference or unauthorized postpetition transfer under §§ 547 and 549.

These cases stand for the proposition that payment to a letter of credit beneficiary by the issuer is not a preferential payment, notwithstanding the bankruptcy of the debtor whose performance is secured by the letter of credit, because no preference occurs when payment depletes the assets of the issuing bank rather than those of the debtor. In re Compton, 831 F.2d at 590; In re Grove Peacock Plaza, 142 B.R. at 514 (payments made by an indorser, surety or guarantor do not effect a preference because there is no transfer of an interest of the debtor in property); M.J. Sales, 25 B.R. at 615 (funds from the issuer do not constitute property of the estate and hence the Bankruptcy Code does not prevent payment to beneficiary).

In contrast, the case here involves a challenge under the Lease. Hechinger is not attempting to set aside the Letter of Credit payment as a preference or unauthorized postpetition transfer. Instead, Hechinger is challenging the existence of Newcourt's claim under the Lease. Hechinger is arguing that it did not owe Newcourt payment for accelerated rent in September 1999. Thus Hechinger maintains Newcourt could not have used the LOC Proceeds to pay the Lease Damages Claim in September 1999 because Newcourt cannot be paid for a nonexistent debt. This argument goes

to Newcourt's right to payment under the Lease, not to its right to draw on the Letter of Credit. Thus the Letter of Credit itself is not at issue and the independence principle is not implicated.

What is at issue, however, is Newcourt's claim for postpetition rent under § 365(d)(10) as an administrative expense. It is self-evident to me that Hechinger has standing to object. I also believe Hechinger may raise as an argument the fact that Newcourt was already paid all postpetition rent due, regardless of the legal mechanism through which Newcourt was paid. Thus I hold that Hechinger has standing to object and that it may contest Newcourt's right to payment of postpetition rent.

I therefor turn to the substance of the motion. Newcourt's position is that Hechinger was in default under the Lease in July 1999. Newcourt claims that Hechinger's failure to pay monthly rent and its filing of a bankruptcy petition that was not dismissed within 60 days are acts of default under paragraph 18 of the Lease. Newcourt's Supplemental Response, p. 3, ¶ 6. Newcourt maintains it became entitled to immediately accelerate the remaining rent due under the lease upon Hechinger's default. Id. It also claims that "upon default and giving notice of default to [Bank Boston], Newcourt was entitled to demand payment of the Letter of Credit." Id. Thus Newcourt states it had a right to accelerate the Lease and to draw on the Letter of Credit in

September 1999 based on Hechinger's default in July.[7]

Newcourt also asserts a right to allocate the LOC Proceeds as it deems fit under the common law of payments. It claims the Letter of Credit was silent on allocation of proceeds and that under the common law, in the absence of a directive by the debtor, a creditor may apply a payment received to whichever mature debt it chooses. Thus Newcourt states it applied the full LOC Proceeds to its Lease Damages Claim in September 1999, which left it with a balance due on the Lease Damages Claim and a right to seek postpetition rent as an administrative expense.

Hechinger's primary argument in response is that the LOC Proceeds paid the Postpetition Rent Claim in full because Newcourt did not have a Lease Damages Claim in September 1999. Consequently, the only claim to which Newcourt could have applied the LOC Proceeds at that time was its claim for postpetition rent.

Second, Hechinger argues that even if Newcourt had two claims in September to which it could have applied the LOC Proceeds, equity requires Newcourt to allocate the proceeds first to the Postpetition Rent Claim and second to the Lease Damages

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7 Newcourt maintains throughout its pleadings that Hechinger defaulted in July 1999 and that this default is the basis of Newcourt's right to accelerate in September 1999. Newcourt does not take the position that Hechinger first defaulted in August or September 1999. The distinction is not material to the outcome. Under the Bankruptcy Code, as discussed *infra*, Newcourt was not entitled to unilaterally accelerate the Lease under either scenario.

Claim. Hechinger maintains that § 365(d)(10) permits the Court to modify a debtor's obligation to pay postpetition rent. Hechinger also claims it would have petitioned the Court earlier for relief from its postpetition obligations under the Lease had it known that Newcourt intended to accelerate payments due and draw on the Letter of Credit. Finally, Hechinger argues that the Bankruptcy Code authorizes this Court to alter the common law of payments.

It seems to me that the decisive issue here is whether Newcourt had a valid Lease Damages Claim in September 1999. I agree with Hechinger that if Newcourt did not have a right to accelerate the Lease at the time it drew on the Letter of Credit, then the only existing claim to which it could have applied the LOC Proceeds in September 1999 was its claim for postpetition rent. In that case the question of payment allocation is moot because, without a Lease Damages Claim, Newcourt would have had to apply the LOC Proceeds to the Postpetition Rent Claim.[8]

On this point, Newcourt argues that it had a valid Lease Damages Claim in September 1999 because the date on which it was entitled to accelerate the Lease was the date on which Hechinger defaulted under the terms of the Lease, i.e., July 1999. For a

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8 Because I decide this matter on the basis of Newcourt's remedies under the Lease, and not on its alleged rights to allocate payment between two mature debts, I need not resolve Newcourt's additional argument that Hechinger lacks standing to dispute payment allocation where a third party made the payments.

number of reasons, I disagree.

First and most troublesome, if Newcourt accelerated the Lease in September, as it claims, then it violated the automatic stay. Under § 541(a), the unexpired Lease was property of Hechinger's bankruptcy estate and it is undisputed that Hechinger was current on the Lease prepetition. Newcourt's self-help in accelerating the Lease in September 1999 was thus an act to exercise control over property of the estate within the meaning of § 362(a)(3). As such, absent court approval which Newcourt did not obtain, it was prohibited. See, e.g., Krystal Cadillac Oldsmobile GMC Truck, Inc. v. Gen. Motors Corp. (In re Krystal Cadillac Oldsmobile GMC Truck, Inc.), 142 F.3d 631, 637 (3d Cir. 1998) (describing automatic stay as a fundamental debtor protection which stops all collection efforts).

An act in violation of the stay, absent annulment, is void. E.g., Gruntz v. County of Los Angeles (In re Gruntz), 202 F.3d 1074, 1082 (9th Cir. 2000); In re Krystal Cadillac, 142 F.3d at 637 (state court's postpetition termination of debtor's franchise agreement in violation of stay was not binding on bankruptcy court); Soares v. Brockton Credit Union (In re Soares), 107 F.3d 969, 976 (1st Cir. 1997)(majority of courts deem act in violation of stay void); Ward v. Bowest Corp. (In re Ward), 837 F.2d 124, 126 (3d Cir. 1988)(foreclosure sale conducted in violation of stay is void and without effect). Consequently, Newcourt had no cognizable claim against Hechinger for accelerated

rent under the Lease in September 1999.

Newcourt attempts to avoid the implication of a stay violation by arguing that its draw under the Letter of Credit is entirely independent from its claim for damages in the Debtor's bankruptcy. This argument misses the point. I need not address Newcourt's rights under the Letter of Credit to conclude that Newcourt's acceleration of the Lease was an exercise of control over property of the estate. Newcourt blurs the distinction between its rights to draw on the Letter of Credit and its rights under the Lease in Debtor's bankruptcy. I make no ruling on the former. On the latter, however, Newcourt was not entitled to accelerate the Lease in September 1999 without first obtaining relief from stay.

In response, Newcourt argues that although it accelerated the Lease for purposes of the Letter of Credit and allocation of the LOC Proceeds in September 1999, it did not accelerate the Lease for purposes of § 362 until Hechinger rejected the Lease in January 2000. Newcourt nevertheless maintains that the Lease Rejection Damages somehow accrued in July 1999. I find no merit to this position. If Newcourt claims, as it does, that it applied the LOC Proceeds to accelerated rent in September 1999 then it is apparent to me that Newcourt accelerated the Lease at that time as well. Furthermore, Hechinger's rejection of the Lease did not give rise to damages in July 1999. A debtor's rejection of an unexpired lease is deemed a prepetition breach and gives rise to a claim for

prepetition damages. 11 U.S.C. § 365(g).

Newcourt was also not entitled to accelerate the Lease in September 1999 because § 365 permits a debtor to assume or reject an unexpired lease of personal property at any time until confirmation of a plan. 11 U.S.C. §§ 365(a), (d)(2). In September 1999 Hechinger had not yet obtained plan confirmation. Consequently, as I see it, Newcourt's options at the time were limited to: (1) demanding adequate protection under § 363(e); (2) compelling Hechinger to fix a time within which to accept or reject the Lease under § 365(d)(2); and (3) compelling Hechinger to make postpetition rent payments under § 365(d)(10). I disagree that Newcourt was entitled to immediately accelerate the Lease based on its unilateral determination that Hechinger was in default, as it asserts. A debtor's right to assume a lease under § 365(a) would be a practical nullity if a lessor were free to accelerate rent during the postpetition prerejection period.

Under § 365(d)(10), I also take issue with Newcourt's conclusion that Hechinger was in default in July 1999. In pertinent part, § 365(d)(10) provides that the debtor:

> shall timely perform all of the obligations of the debtor, except those specified in section 365(b)(2), first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property (other than personal property leased to an individual primarily for personal, family, or household purposes), until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and

> a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof. ...
>
> 11 U.S.C. § 365(d)(10)

Section 365(d)(10) requires a lessee to pay contractually agreed upon rent that comes due after the sixty-day abeyance period. In re Pan Am. Airways, Corp., 245 B.R. 897, 900 (Bankr. S.D. Fla. 2000); In re Kyle Trucking, Inc., 239 B.R. 198, 201 (Bankr. N.D. Ind. 1999). To the extent the lessee fails to do so, the lessor is entitled to an administrative claim. In re Kyle Trucking, Inc., 239 B.R. at 201. However, the lessee is relieved from its duties to perform under an unexpired equipment lease for the first sixty days after the order for relief is entered. In re Pan Am. Airways, Corp., 245 B.R. at 900; In re Kyle Trucking, Inc., 239 B.R. at 201. By expressly incorporating § 365(b)(2), § 365(d)(10) also invalidates a contractual default based on a lessee's insolvency or bankruptcy filing.

Accordingly, Newcourt's assertion that "there can be no real dispute that [Hechinger] was in Default under the lease as of July, 1999" and that upon default, "Newcourt, without notice, became entitled to immediately accelerate the remaining rent due under the Lease" is incorrect. Hechinger was not in default under the Lease as of July 1999 because Hechinger had no duty to perform at that time. Thus even without consideration of the automatic stay, Newcourt was not entitled to accelerate the Lease in July

1999 and it consequently did not have a claim for damages on this basis in September 1999.

I am also not convinced that Hechinger was in default under the terms of the Lease itself. First, Newcourt's argument that Hechinger's bankruptcy filing was an event of default in July 1999 is flawed. Under the Lease, as Newcourt concedes, a bankruptcy filing is not an event of default if the bankruptcy is dismissed within sixty days. Hechinger's bankruptcy filing therefor could not have been an event of default as of July 1999 because sixty days had not yet elapsed.

Second, paragraph 18, as modified by Exhibit A to the Master Lease Schedule at A.1, defines "default" in pertinent part as follows:

> You will be in default under a Schedule if: (i) you do not pay an installment of Monthly Rental or any other charge within ten days after the date it becomes due and you have been provided five days written notice; (ii) you do not perform any other obligation unless you fully perform the obligation within thirty days after you first learn or are notified of the unfulfilled obligation;...(emphasis added).

The Lease therefore requires notice of default, although as Newcourt points out, the Lease does not require notice for acceleration upon an occurrence of default. Newcourt relies on paragraph 18 which states in relevant part:

> Upon the occurrence of a default, Sun Data, may, at its option, and without notice, at any time thereafter do one or more of the following: . . . (ii) declare any and all unpaid Monthly rental to be immediately due and payable.

Although the Lease does not require notice of acceleration, a prerequisite for acceleration is nevertheless an "occurrence of default," which does require notice. Thus it appears to me that Hechinger's failure to pay postpetition rent without five days written notice by Newcourt is not an event of default. Consequently, it seems to me that even absent Hechinger's rights in bankruptcy, Newcourt did not have a contractual basis on which to accelerate the Lease. I will refrain from making a ruling on the contractual basis of Newcourt's claim because the parties dispute the notice given in this case. I need not decide the issue to conclude that Newcourt did not have a claim for accelerated rent under the Lease in September 1999.

I note in closing that my conclusion is independent from Newcourt's rights under the Letter of Credit. I make no ruling on whether Hechinger's failure to pay postpetition rent was a "default" for purposes of Newcourt's representation to Bank Boston. Nor do I decide whether Newcourt's draw on the Letter of Credit was otherwise lawful. My holding today is limited to a finding that under the Bankruptcy Code, Newcourt was not entitled to unilaterally accelerate the Lease in September 1999 and accordingly, Newcourt's Lease Damages Claim did not exist at that time.

CONCLUSION

For the reasons set forth above, I deny Newcourt's motion. I hold that the LOC Proceeds have fully compensated Newcourt for the Postpetition Rent Claim because it was the only claim to which Newcourt could have applied the LOC Proceeds in September 1999. Because Newcourt's administrative claim is paid in full, the allocation of payment issue is moot and Newcourt's motion is denied.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
HECHINGER INVESTMENT COMPANY OF DELAWARE, INC., et al.,	)	Case No. 99-2261 (PJW)
	)	
	)	(Jointly Administered)
Debtors.	)	

ORDER

For the reasons set forth in the Court's memorandum opinion of this date, it is hereby ordered that the Motion of Newcourt Leasing Corporation , f/k/a AT&T Capital Leasing Services, Inc., to Compel Payments Required Under 11 U.S.C. § 365(d)(10), or Alternatively, for Adequate Protection Payments (Doc. # 1020) is DENIED.

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Peter J. Walsh
United States Bankruptcy Judge

Date: January 29, 2001