

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:)
)
PAPIO KENO CLUB, INC.,) CASE NO. BK97-82482
)
DEBTOR.) A98-8017
_____)
PAPIO KENO CLUB, INC.,)
) CH. 11
Plaintiff,)
vs.)
)
CITY OF PAPIILLION,)
)
Defendant.)

MEMORANDUM

Hearing was held on April 28, 1999, on the Adversary Complaint. Appearances: Robert Ginn and Scott Daniel for plaintiff, Robert Becker and Anne Grottveit for the City of Papillion. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52.

Background

Debtor Papio Keno Club, Inc., ("Papio Keno") entered into a Lottery Operator Agreement ("Agreement") with the City of Papillion ("City") on September 15, 1992, which Agreement was either amended or supplemented on four separate occasions thereafter. (Exhibit 14) Pursuant to the Agreement, Papio Keno, as contractor, was to run a keno-type lottery within the city limits of Papillion for a term of five years, during which time the City could cancel the Agreement upon fifteen days' notice, provided such termination was not arbitrary, capricious, or unreasonable.

The Agreement contained express provisions pertaining to, inter alia, insurance, food concessions, compensation and proceeds, liability and indemnification, and a performance bond. The parties operated according to this Agreement, with its subsequent amendments and supplements, without significant incident until August 25, 1997, when the City drew down \$121,179.29 on a \$250,000 Letter of Credit issued on behalf of Papio Keno which had served as the performance bond required

by the Agreement. The City also obtained from Papio Keno the transfer of a Certificate of Deposit ("CD") in the amount of \$169,329.71 which had served as a cash reserve for jackpot winners. The City subsequently made a second draw on the Letter of Credit in the amount of \$128,820.71 on September 19, 1997, and terminated the Agreement as of September 30, 1997. Shortly thereafter, Papio Keno filed its petition under Chapter 11 of the Bankruptcy Code.

Papio Keno seeks an accounting and a turnover of the funds drawn down on the Letter of Credit and of the funds obtained through the transfer of the CD. Papio Keno alleges that the funds should be returned to the debtor's estate because the transfers were either fraudulent transfers of the debtor's property under 11 U.S.C. § 548 or preferential transfers under 11 U.S.C. § 547, and has styled two of the counts of its complaint as a turnover action under 11 U.S.C. § 542. Papio Keno also alleges that the City breached the Agreement by terminating it without due cause.

The City has resisted all demands by Papio Keno to return the funds, maintaining that Papio Keno never had an interest in the funds represented by the Letter of Credit, and that the CD was purchased with the City's funds and was, therefore, never property of Papio Keno. The City further maintains that Papio Keno breached the Agreement by failing to satisfactorily address alleged deficiencies under the Agreement, and that the draw down of the Letter of Credit was for liquidated damages provided for in the Agreement and for unclaimed wins owed the City by Papio Keno.

Issue

The main issue in this case is whether the City breached its contractual obligations to Papio Keno by drawing down on the Letter of Credit without cause, taking for itself all of the funds in the "Progressive Jackpot" account, and arbitrarily and capriciously terminating the Agreement.

Decision

1. The Letter of Credit represents an Agreement between the City and Springfield State Bank and was not property of Papio Keno or its estate.

2. The draw down on the Letter of Credit is neither a fraudulent transfer nor a preferential transfer as those terms are defined in the Bankruptcy Code.

3. A portion of the "Progressive Jackpot" fund which was held by Papio Keno in the form of a CD is property of the City because the source of the money in the CD was the City's share of the keno operation's gross revenues.

4. Papio Keno was in material breach of the Agreement on August 25, 1997, and the City did have the right to demand a transfer of the "Progressive Jackpot" fund and did have a right to draw down on the Letter of Credit. Additionally, it had the right to terminate the Agreement for failure to cure the deficiencies.

5. The City breached the Agreement by failing to deliver to Papio Keno certain funds at the termination of the Agreement. Papio Keno has the right to a turnover of that portion of the \$419,329.71 received by the City which does not represent funds owned by the City or contractual payments due the City. The amount to be turned over to Papio Keno is \$182,597.00.

Findings of Fact

The Agreement entered into between Papio Keno and the City on September 15, 1992, required Papio Keno to be fully responsible for paying all prizes to the winners. To assure that Papio Keno had the capability of completely performing the Agreement, including paying prize winners, the Agreement had two separate, but similar provisions. First, Paragraph 12 required Papio Keno to post a "Performance and Payment Bond" in the amount of \$250,000.00 or, in lieu of such bond, Papio Keno was authorized to file with the City an irrevocable Letter of Credit in that amount. In compliance with Paragraph 12, Papio Keno did supply to the City an irrevocable Letter of Credit in the amount of \$250,000.00.

In addition to the bond requirement at Paragraph 12, the Agreement, at Paragraph 14, separately required Papio Keno to deposit with the City a cash reserve equaling two times the amount of the maximum prize that could be won at any regular game plus the amount available to be won in any progressive, special or promotional game. In lieu of such a cash reserve,

Papio Keno was authorized to provide comparable security in the form of a bond, letter of credit or other security.

If Papio Keno provided such security in the form of a cash reserve, Paragraph 14 of the Agreement made it clear that such a cash reserve actually belonged to Papio Keno and that at the termination of the Agreement, after all prizes and claims had been paid, the cash reserve, with accumulated interest, would be returned to Papio Keno.

Papio Keno did not establish a cash reserve to be held by the City. Until August 25, 1997, Papio Keno did not deliver to the City any funds to be considered a cash reserve. The City did not receive from Papio Keno and did not invest any such funds as would have been required by Paragraph 14.2(f) had the City actually received such funds.

From September of 1992 through late August of 1997, the City and Papio Keno operated as if there either was no requirement for such a cash reserve, or as if the \$250,000.00 Letter of Credit delivered to the City pursuant to Paragraph 12 of the Agreement was sufficient to cover the obligations of Papio Keno under both Paragraph 12 and Paragraph 14.

In August of 1993, the Agreement was amended. See Exhibit 14. That amendment apparently was intended to permit Papio Keno to offer a "Progressive Jackpot," a term that is not defined in the amendment. It also authorized, at Paragraph 5.3 of the amendment, Papio Keno to pay 1% of the gross proceeds each month toward the "Progressive Jackpot" until the Jackpot reached \$200,000.00. Once the Jackpot reached \$200,000.00, the 1% monthly contribution was to be paid to the City in addition to all other funds that were to be paid to the City under the terms of the Agreement and its amendments. The amendment did not alter the maximum percentage of the gross monthly revenue which was to be kept by Papio Keno as its compensation for operating the games. Although not explicit in the amendment language, the 1% contribution was to come from the City's share of the gross revenues.

The August, 1993, amendment does not specify either the manner in which Papio Keno was to pay the 1% of the gross proceeds each month toward the "Progressive Jackpot," or the type of account in which such 1% payment was to be deposited. In the amendment, there is no reference to a separate bank

account, a trust account or an escrow account into which such funds would be deposited. The amendment itself, by its own terms, does not require such a payment. It simply authorizes Papio Keno to make such a payment. The amendment also did not explicitly amend Paragraph 14.2(g) which required the cash reserve fund to be delivered to Papio Keno at the termination of the Agreement.

Exhibit 22 is a compilation of daily and monthly records of the keno operation from May of 1993 to August of 1997. Exhibit 22 includes monthly reports to the City of Papillion which show the gross keno proceeds and the percentage payable to the City. Exhibit 22 also includes a summary of the daily monetary operations of Papio Keno, calculations concerning the monthly amount payable to Papio Keno from the gross proceeds, the monthly amount payable to the City from the gross proceeds, and a 1% amount payable to "Progressive."

There is nothing in Exhibit 22, or in any other evidence in this record, that shows any actual payment by Papio Keno to an account designated as the "Progressive Jackpot" account. However, Exhibits 23 and 24, "financial statements" which were prepared by the accountant for Papio Keno and which purport to represent the financial condition of Papio Keno in July of 1997 and August of 1997, include as an asset an item entitled "Restricted Cash-Progressive Game \$168,639.00." The actual money represented by the asset listing was held in the CD delivered to the City on August 25, 1997.

The fund of approximately \$169,000.00 represented by the CD was started by Papio Keno by an initial deposit in a money market account at the Springfield State Bank in May of 1993. That date precedes the August, 1993, amendment to the Agreement that deals with a "Progressive Jackpot." Exhibit 4 shows the history of the money market account. From May of 1993 through January of 1995, except for April and May of 1994, Papio Keno deposited funds into the money market account which, with accruing interest, allowed the account to increase from the initial deposit of \$11,815.00 in May of 1993 to \$134,900.00 in January of 1995. That money market account was solely in the name of Papio Keno.

In January of 1995, Papio Keno withdrew \$134,900.00 and purchased a CD in that amount. No additional deposits were made to the account. The account was rolled over at maturity with accrued interest added. On August 25, 1997, the day that

the CD was transferred to the City, the balance, including accrued interest, was \$169,329.71.

As of January, 1995, after which date no deposits were made, the actual principal amount which had been deposited to the account was \$132,500.00. Papio Keno had deposited \$25,458.00 to the fund in May, June and July of 1993, prior to the start of the authorized 1% per month which was to have been paid into the "Progressive Jackpot." Therefore, the amount deposited into the "Progressive Jackpot" fund between August of 1993 and January of 1995 was \$107,042.00.

A comparison of Exhibit 22 to Exhibit 4 shows that the actual monthly deposits to the fund from August, 1993, through the middle of 1995 do not exactly match the 1% amounts shown as accrued on Exhibit 22. However, beginning in the late summer of 1994, the accrued amounts due shown on Exhibit 22 track very closely to the actual deposits made as shown on Exhibit 4.

On August 25, 1997, the City insisted that the amount in the CD, which the City claimed represented the obligation of Papio Keno under the amended Agreement to create a fund of \$200,000.00 for the "Progressive Jackpot," be transferred to the City. Papio Keno did make arrangements with Springfield State Bank to transfer the CD to the City.

Once it had received the amount of \$169,329.71 from Papio Keno, the City determined that Papio Keno was not in compliance with that portion of the lottery operator agreement at Paragraph 14.2(a) which required the debtor to keep on deposit with the City "the sum of the maximum prize possible to be won in the regular game plus the amount available to be won in the 'Progressive Jackpot.'" It claimed the required amount was \$250,000.00. Therefore, the City made demand upon the Springfield State Bank for \$80,670.29 from the Letter of Credit which was to be combined with the \$169,329.71 in the CD to make up the total of \$250,000.00, thereby covering the City's exposure to claims of winners of the games. In addition, on that first draw against the Letter of Credit, the City demanded \$40,509.00 to cover "unpaid wins," the funds for which had not been paid over to the City as required by the terms of the Agreement.

As soon as the City made demand upon Springfield State Bank for the initial payment on the Letter of Credit, the Bank

notified Papio Keno that it was calling upon Papio Keno to make good on a promissory note which had been provided to the Bank as security for the Letter of Credit. When payment was not immediately made to the Bank, the Bank notified the City that it was terminating the balance of the Letter of Credit within thirty days, pursuant to its terms.

The initial draw down on the Letter of Credit and the notice to the City that the Bank would cancel the Letter of Credit within thirty days, caused the City officials to review once again the obligations of Papio Keno under the Agreement. The City officials determined that Papio Keno was not in compliance with its obligations. First, since there had been a draw down on the Letter of Credit, and the Letter of Credit had not been replenished, Papio Keno was not in compliance with that requirement of the Agreement which provided that it would post a Letter of Credit in the amount of \$250,000.00.

Second, the Agreement required general liability insurance in the amount of \$5 million, but the debtor had only obtained \$4 million of coverage. The City considered the coverage deficiency to be a material breach of the Agreement.

Third, as represented by Exhibit 19, Resolution 977, a resolution of the City Council of the City of Papillion adopted on the 15th of September, 1997, Papio Keno was notified that the Agreement would be terminated for specific reasons, including failing to obtain a renewal of the charitable gaming license from the State of Nebraska; failing to obtain or maintain a performance bond or a letter of credit in the amount of \$250,000.00; and by failing to have each employee subjected to a complete and thorough background investigation prior to, and throughout the term of employment. The resolution states that in partial satisfaction of the described material breaches, liquidated damages would be charged against the Letter of Credit for the first material breach of \$2,500.00 per day and for the second and subsequent material breaches of \$5,000.00 per day. The resolution further authorized the City Clerk to draw down on the balance of the Letter of Credit to collect the liquidated damages.

Following the adoption of Resolution No. 977, the City Clerk identified for the Mayor and City Council members and the Acting City Administrator, in Exhibit 18, a specific listing of items which "appear to constitute a material breach of the keno contract." That list includes a statement that

the failure to have \$5 million in general liability coverage instead of the \$4 million in general liability coverage that actually was provided, was the "first breach" under the Agreement. The additional million dollars in liability insurance had not been available for the protection of the City from March 1, 1993, (a date which is not in the Agreement but which may be the date the keno operation actually started), to September 10, 1997, for a total of 1,653 days. For such breach, the City Clerk claimed the liquidated damage amount, at \$2,500.00 per day, amounted to \$4,132,500.00.

The list also includes, as a "material breach," the failure of Papio Keno to submit all of the documents necessary to obtain a gambling license by August 1, 1997. The City Clerk calculated the damages to the City at the rate of \$5,000.00 a day for forty-one days from August 1, 1997, to September 10, 1997, for a total of \$205,000.00.

On September 17, 1997, the City notified Springfield State Bank that it was drawing down the balance on the Letter of Credit in the amount of \$128,820.71. The reasons stated for the draw down, as shown in Exhibit 13, included a failure by Papio Keno to comply with federal, state or local law, rules and regulations pertaining to keno; failing to provide material information required to be disclosed by the Agreement; failing to provide license renewal application to the State of Nebraska, Department of Revenue; and failing to obtain and/or maintain a performance bond and/or letter of credit as required in Paragraph 12 of the agreement. The Bank paid out on the Letter of Credit.

This record does not reflect what problems existed between the City and Papio Keno prior to August of 1997. However, there was testimony from a city employee that a new city administrator came on board in the summer of 1997 and that person requested a review of all city contracts, including the Papio Keno Agreement. Upon review of the Agreement, it was discovered that Papio Keno was not in strict compliance with the terms of the Lottery Agreement. First, it did not have \$5 million of general liability insurance as required by the Agreement. Second, there was no cash reserve as identified in Paragraph 14.2 actually deposited with the City to assure payment to winners of the regular and/or Progressive Game. Third, the debtor had not paid all of the unclaimed winnings to the City for a significant amount of time. Fourth, Papio Keno was not in compliance with an

earlier supplemental agreement which required Papio Keno to make \$500.00 per month payments to the City on unclaimed winnings and to expend \$19,000.00 in additional advertising to satisfy its obligation to the City with regard to unclaimed funds. Fifth, the City had not received adequate information from Papio Keno concerning the names of its employees and there had not been current background investigations performed with regard to those employees since November of 1996. Sixth, Papio Keno had not paid the City for the audit expense of \$6,000.00.

Based upon the information determined by the city employees, the City did have a contractual right to demand that Papio Keno cure the deficiencies. It had the right to request a cash reserve fund be deposited with it in the amount of \$250,000.00 to cover all obligations with regard to regular and progressive games. It had the right to demand additional insurance coverage. It had the right to demand that Papio Keno provide adequate information both to the City and the State of Nebraska with regard to the employees and to obtain current background checks on the employees. Finally, it had the right to demand that Papio Keno do everything required by the State of Nebraska to obtain a renewal of its keno license prior to its expiration on September 30, 1997.

Since Papio Keno was in default under those provisions of the Agreement which required it to provide cash or other security to assure payment of winnings, up to a maximum amount of \$250,000.00, the City had a right to draw on the Letter of Credit as a result of such failure. It also had a right to demand that the funds held by the debtor for the "Progressive Jackpot" be transferred to the City to be combined with a portion of the proceeds of the Letter of Credit to total the sum of \$250,000.00.

The City had the right to drawn on the Letter of Credit to collect the \$40,509.00 in unclaimed winnings that Papio Keno had failed to pay over to the City. The debtor presented the testimony of an accountant at trial with regard to the question of whether or not unclaimed winnings had been timely paid over, but such testimony is not consistent with the financial statements which showed the debtor owed approximately \$40,000.00 in unclaimed winnings and the testimony is not consistent with the audit results which also referred to unclaimed winnings.

Although, under the facts as representatives of the City knew them in August and September, 1997, the City had the right to demand the funds referred to above, once the Agreement was terminated, the City had the contractual duty to turn over to Papio Keno all funds not representing money actually belonging to the City under the Agreement. As mentioned above, although the CD had a value of \$169,329.71 on the date it was transferred to the City, at least \$25,458.00 of that amount had been deposited to the account prior to the effective date of the August, 1993, amendment which authorized Papio Keno to withhold from the City's portion of the gross proceeds 1% per month for the "Progressive Jackpot." Therefore, at least \$25,458.00 of the \$169,329.71 amount in the CD belongs to Papio Keno under Paragraph 14.2(g) of the Agreement.

The City drew down \$80,670.29 from the Letter of Credit to complete the fund necessary to protect it from any liability related to paying out on the regular game or the "Progressive Jackpot." However, upon termination of the Agreement at the end of September, 1997, and as of the date of trial, there had been no winner of the "Progressive Jackpot" and there has been no demand upon the City for any payment on the "Progressive Jackpot" or other games resulting from the operation by Papio Keno.

That \$80,670.29 drawn from the Letter of Credit was not generated by withholding 1% of the gross monthly proceeds from the City's share. The Agreement specifically provides, at Paragraph 14.2(g), that upon termination, the cash reserve shall be returned to Papio Keno. The August, 1993, amendment implicitly alters the terms of Paragraph 14 by authorizing the creation of a "Progressive Jackpot" fund with 1% of the gross receipts. According to the August, 1993, amendment, that 1% contribution to the fund clearly was to come from the City's share of the gross proceeds. Therefore, the City owns that portion of the fund represented by contributions made from and after August, 1993, until the transfer of the CD in August, 1997. The balance of the fund did not come from the City's share of the gross proceeds and does not belong to the City. Per the Agreement, at Paragraph 14.2(g), it belongs to Papio Keno.

The City did have a right to draw down on the Letter of Credit to pay the \$40,509.00 unclaimed winnings, and it did have a right to draw down on the Letter of Credit to cover a

\$6,000.00 audit obligation of the debtor. Therefore, the City may keep that \$46,509.00.

The only remaining claim the City has against Papio Keno under the Agreement is for the City's share of the gross revenue from the keno operation in September of 1997 plus the September unclaimed wins, for a total of \$51,480.66. (Exhibit 43). This amount is due the City and is payable to the City pursuant to the terms of Paragraph 12.

After dealing with the \$80,670.29 that is due Papio Keno from the Jackpot fund and the \$46,509.00 which appropriately has been kept by the City to cover actual damages and the \$51,480.66 for September, 1997, revenues, there is \$71,341.00 from the Letter of Credit still to be dealt with. The City claims that it has a right to keep the \$71,341.00 as liquidated damages.

The Agreement at Paragraph 8 permits the City to terminate the Agreement if Papio Keno commits a material breach. The paragraph then itemizes numerous specific acts which are determined to be "material breaches."

Paragraph 8(d) lists "[T]he failure to comply with any federal, state or local law, rules or regulations pertaining to keno."

Paragraph 8(f) provides "[T]he failure to provide material information, the furnishing of false information, or the omission of material information as required to be disclosed by Contract or under this Agreement, the Specifications for Lottery or the Contractor's Proposal;"

Paragraph 8(j) provides "[T]he failure to obtain and/or maintain insurance coverage as required in Paragraph 11."

Paragraph 8(k) provides "[T]he failure to obtain and/or maintain a performance bond and/or letter of credit as required in Paragraph 12."

The Agreement at Paragraph 31 provides for liquidated damages. Paragraph 31.1 states:

In complete and partial satisfaction of any material breach, liquidated damages may be

chargeable to the letter of credit or performance bond in the following amounts:

(a) First material breach: \$2,500.00 per day the breach continues or occurrence.

(b) Second and subsequent material breach: \$5,000.00 per day the breach continues or occurrence.

The City now asserts, as represented by Exhibit 18, that the first breach resulting in liquidated damages of \$2,500.00 per day is the failure to obtain insurance coverage as required in Paragraph 11. Paragraph 11 required that Papio Keno obtain general liability insurance in the amount of \$5 million, and, from day one under the Agreement, Papio Keno had obtained only \$4 million in general liability insurance. The City claims that each day from March 1, 1993, to September 10, 1997, for a total of 1,653 days, Papio Keno had materially breached the Agreement and was subject to liquidated damages of \$2,500.00 per day or \$4,132,500.00. However, when the City made demand upon the bank for payment under the Letter of Credit, the City did not claim any liquidated damages on the insurance breach and did not use the insurance deficiency as a reason for the draw down.

A representative of the City testifying at trial admitted that the City had no actual damages as a result of the failure of Papio Keno to increase the general liability insurance coverage from \$4 million to \$5 million. The City had become aware of the difference in the contractual obligation and the actual policy limits sometime in 1995, but was assured by the insurance agent that the policy limits of \$4 million were sufficient to protect the interest of the City from any claim. The City, having knowledge of the situation from 1995 on, did not act on such knowledge, notify Papio Keno of its default, or consider the failure to comply with the contractual provisions a material breach until August of 1997.

The second material breach asserted by the City is the failure, under Paragraph 8.1(d), of Papio Keno to comply with any federal, state or local law, rules or regulations pertaining to keno and specifically failing to submit a complete license renewal application including attachments by August 1, 1997, to the State of Nebraska, Department of Revenue. As liquidated damages for such a breach for the

forty-one days from August 1, 1997, to September 10, 1997, the City claims liquidated damages of \$205,000.00 at the rate of \$5,000.00 per day.

The City was not damaged by this so-called material breach. The debtor did file an application with the State for renewal of the keno license. The debtor did obtain a renewal of the keno license before the expiration of the original license at the end of September in 1997. Therefore, there could not have been any actual damages and the alleged material breach was not a breach at all. The City's claim for liquidated damages fails.

The third material breach itemized by the City in Exhibit 18 concerns Paragraph 8.1(k). The City claims that Papio Keno committed a material breach by failing to maintain a performance bond or letter of credit as required in Paragraph 12. There is no question that after the City drew down on the Letter of Credit on August 25, 1997, Papio Keno did not replenish the Letter of Credit and, therefore, was in default. However, there is absolutely no evidence that the City has been damaged in any amount by such default. Paragraph 12 required either a performance and payment bond or a letter of credit "to guaranty Contractor's full and complete performance of this Agreement, including payment to the City of all sums due hereunder."

The City was exposed to potential claims which would have been covered by the gross amount of the Letter of Credit, for a period extending from August 25, 1997, the date the City drew down on the letter and caused the default, through September 30, 1997, the date of termination of the agreement. No claims were made during that period.

The City has incurred no actual damages from the "material breach" regarding the general liability policy; no actual damages resulting from the failure to maintain a Letter of Credit from August 25, 1997, through September 30, 1997; no actual damages from the alleged, but not real, material breach concerning the failure to obtain a license renewal. As will be explained in the "Conclusion of Law" section of this memorandum, the "liquidated damages" provision of Paragraph 31 is an unenforceable penalty, and the City has no right to keep any funds as "liquidated damages." Therefore, the \$71,341.00 remaining proceeds from the Letter of Credit must be turned over to Papio Keno as damages for breach of the Agreement.

The preceding discussion of the breakdown of the \$419,330.00 now held by the City is summarized in Table A.

TABLE A

<u>City</u>		<u>Papio Keno</u>	
Unclaimed Wins Ex. 3	40,509	Certificate of Deposit	25,488
Audit Expense Ex. 41	6,000	Interest	5,098
September 97 Share of gross and unclaimed wins Ex. 7	51,481	Balance of Progressive Jackpot Fund	80,670
City's share of principal of Certificate of Deposit	107,012	Balance of Funds from Letter of Credit	71,341
City's Share of CD Interest Earned	<u>21,731</u>		<u> </u>
	\$226,733		\$182,597

The interest allocation was calculated by determining that the \$25,488.00 early deposit by Papio Keno was 19% of the total money deposited, \$132,500.00. Papio Keno has a right to 19% of the total interest earned, \$26,829.00.

Conclusions of Law

A. The Letter of Credit

Papio Keno contends that the Letter of Credit, like the CD, was property of Papio Keno, and that the City's draw downs on the Letter of Credit therefore constituted either preferential transfers under 11 U.S.C. § 547(b), or fraudulent conveyances under 11 U.S.C. § 548(a)(1)(B). However, it is a settled point of law that a Letter of Credit and its proceeds are not property of the debtor's estate under 11 U.S.C. § 541. Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 589 (5th Cir. 1987). See also In re Leisure Dynamics, Inc., 33 B.R. 171, 177 (Bankr. D. Minn. 1983); In re Illinois-California Exp., Inc., 50 B.R. 232, 235 (Bankr. D. Colo. 1985); Lower Brule Const. Co. v. Sheesley's Plumbing & Heating Co., Inc., 84 B.R. 638, 644

(D.S.D. 1988); and In re Security Services, Inc., 132 B.R. 411, 414 (Bankr. W.D. Mo. 1991).

In Counts II, IV, and V of its complaint, Papio Keno seeks the return of the funds drawn down on the Letter of Credit, yet all of the counts are premised on the erroneous conclusion that Papio Keno had a property interest in the Letter of Credit. Any compensation to which Papio Keno might be entitled as a result of the alleged inappropriate draws on the Letter of Credit and alleged violations of the Agreement and damages accruing therefrom must be determined in the context of the breach of Agreement claim, Count VI.

The City, by drawing down the balance of the Letter of Credit on the strength of the liquidated damages paragraph in the Agreement, to compensate itself for alleged damages caused by material breaches by Papio Keno, did not create an avoidable preference under 11 U.S.C. § 547 because the Letter of Credit funds were not property of the debtor. Had such funds been property of the debtor, then their use to pay the \$40,509.00 unpaid winnings, the \$6,000.00 audit fees and \$51,481.00 to cover the City's share of the September gross keno proceeds plus the September unclaimed winnings would have been a preference under § 547. Obviously, that is because Papio Keno was insolvent, the transfer provided the City more than it would have received in a Chapter 7 case had the transfer not taken place and the transfer took place within ninety days of the filing of the bankruptcy petition. In this case, however, the City had a right to draw down on the Letter of Credit because it was separate and independent from property of the debtor and it was in the nature of "security" for any actual damages resulting from a material breach of the Agreement.

B. Count VI-Breach of Agreement

The City did not breach the Agreement with Papio Keno by taking possession of the "Progressive Jackpot" fund, drawing down the Letter of Credit, or terminating the Agreement for cause. However, the City did breach the Agreement by refusing to turn over to Papio Keno, pursuant to Paragraph 14.2(g), the \$80,670.00 added to the fund by the Letter of Credit draw down and refusing to turn over to Papio Keno the funds contributed by Papio Keno prior to the August, 1993, amendment, and by refusing to turn over the amount of \$71,341.00 which represents the claimed "liquidated damages" received by the City from the final draw down of the Letter of Credit.

The liquidated damages paragraph of the Agreement, Paragraph 31, provides for damages of \$2,500.00 per day for the first material breach and \$5,000.00 for any additional breach. The Agreement does not include any language from which it could be determined that such amounts are a reasonable estimate of the actual damages the City would suffer if Papio Keno failed to provide sufficient liability insurance or failed to obtain background reports on all employees, or failed to replenish the Letter of Credit or deposit the cash reserve with the City. The potential actual damages were not difficult to estimate. Any amount of general liability insurance obtained by Papio Keno that was less than the contractually required amount of \$5 million left the City exposed by such amount. Because Papio Keno obtained only \$4 million of general liability insurance, the actual maximum exposure to the City was \$1 million. The City knew of the deficiency in 1995, checked on its exposure and did not require an increase in the general liability policy limits for over two years. It then claimed liquidated damages at \$2,500.00 per day for over four years, resulting in the ludicrous claim of liquidated damages of over \$4 million.

The law in Nebraska concerning the validity of a liquidated damages provision is that such a provision will be upheld if, (1) the actual damages are difficult to ascertain, and (2) that the contractually specified damages are a reasonable estimate of actual damages. Gronney v. CMH Real Estate Co., 195 Neb. 398, 238 N.W.2d 240 (1976), Browning Ferris Ind. Of Nebr., Inc., v. The Eating Establishment-90th & Fort, Inc., 6 Neb. App. 608, 575 N.W.2d 885 (1998).

The question of whether the payment stipulated in the Agreement is liquidated damages or a penalty is a question of law. Standford Motor Co. v. Westman, 151 Neb. 850, 39 N.W.2d 841 (1949). In this case, there is no reasonable relationship between the liquidated damages provision of Paragraph 31 and any estimate of actual damages. Therefore, the per diem amount of damages provided as "liquidated damages" in the Agreement is a penalty, and unenforceable.

The City holds \$71,341.00 it received from the Letter of Credit draw down on its liquidated damages theory. The City has shown no actual damages from the asserted breaches. The \$71,341.00 it received from the Letter of Credit draw down created a \$71,341.00 debt from Papio Keno to Springfield State Bank which Papio Keno would not have incurred had the claim of liquidated damages not been made. Making such a claim and

causing the bank to pay such amount is a breach of the Agreement which limited a draw down of the Letter of Credit to provide the City only with payment of all sums due under the Agreement.

The City has no actual, unpaid damages resulting from the asserted material breaches. The liquidated damages provision is an unenforceable penalty, and the damages caused to Papio Keno from the unauthorized draw on the Letter of Credit is equal to the \$71,341.00 now held by the City.

C. Turnover

The Bankruptcy Code, at 11 U.S.C. § 542(a), provides that upon the filing of the bankruptcy petition, a party in possession of property of the bankruptcy estate shall deliver such property to the trustee. As discussed above, the City held on the petition date, and continues to hold, \$182,597.00 which is property of the bankruptcy estate. Papio Keno, the debtor-in-possession, exercising the powers of a trustee, made a demand for a turnover of the property and such demand has been refused. The City is now ordered to turn over the \$182,597.00 which is property of the bankruptcy estate.

D. Accounting

The Complaint requests an accounting from the City. Such a request contemplates an equitable remedy, but Papio Keno has an adequate remedy at law because a money judgment will be entered in favor of Papio Keno and against the City of Papillion, Nebraska, in the amount of \$182,597.00. Therefore, the request for an accounting is denied.

Separate judgment shall be entered.

DATED: August 20, 1999

BY THE COURT:

/s/Timothy J. Mahoney
Chief Judge

Copies faxed by the Court to:

12 BECKER, ROBERT
39 GINN, ROBERT

Copies mailed by the Court to:

United States Trustee

Movant (*) is responsible for giving notice of this journal entry to all other parties (that are not listed above) if required by rule or statute.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:)
)
PAPIO KENO CLUB, INC.,) CASE NO. BK97-82482
) A98-8017
DEBTOR(S).)
_____) CH. 11
PAPIO KENO CLUB, INC.,) Filing No.
Plaintiff(s))
vs.)
)
CITY OF PAPIILLION,)
)
Defendant(s).)

JUDGMENT

1. Judgment is entered on Count VI, Breach of Contract, in favor of the plaintiff, Papio Keno Club, Inc., and against the defendant, City of Papillion, Nebraska, in the amount of \$182,597.00 with interest to accrue at the federal judgment rate from and after the entry of the judgment.

2. The City is ordered to turn over such amount.

3. Judgment is entered in favor of the City of Papillion, Nebraska, on all remaining counts.

See memorandum entered this date.

DATED: August 20, 1999

BY THE COURT:

/s/Timothy J. Mahoney
Chief Judge

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