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Reporting Recent Legal Developments Important To Lending In Louisiana

By the Bankruptcy and Commercial Lending Groups of Lemle & Kelleher, L.L.P.

Bankruptcy Reform—Are You Ready For the Impact on Business Bankruptcy?

The Bankruptcy Abuse Prevention & Consumer Protection Act of 2005 (the "Act") not only made sweeping changes to consumer bankruptcy filings, the Act also made important amendments that affect business bankruptcies. Many of these amendments will have a direct impact on lenders' rights. With certain exceptions, the Act applies to cases commenced on or after October 17, 2005. Here is a quick summary of some of the changes that may impact you in a business bankruptcy.

Sellers of Goods – Two Big Changes to Reclamation Rights

First, a seller of goods in the ordinary course of business will now have an administrative expense claim for the "value" of goods received by the debtor within 20 days before the commencement of case when the seller has not reclaimed the goods. Second, sellers of goods may make a reclamation demand for goods delivered to the debtor within 45 days of the bankruptcy filing. The demand must be made within 45 days of the debtor's receipt of goods or, if the 45-day period has not expired at the time of the filing, the seller will have 20 days from the filing. The goods still must be in possession of the debtor and the seller's reclamation rights are still subordinate to the rights of a secured lender in the goods.

Another Cash Drain On Filing

In addition to the cash demands of having to pay certain reclamation claims as administrative expenses, debtors will now have to come up with cash or other real security to provide utilities adequate assurance of payment. Chapter 11 debtors frequently were able to do nothing more than offer utilities an administrative expense claim to provide the adequate assurance of payment required by the Code. The Act provides that an administrative expense claim is *not* adequate assurance of payment. Thus, to avoid a discontinuance of utility service, a debtor must provide a cash deposit, letter of credit, certificate of deposit, surety bond, prepayment or other form of security acceptable to the debtor and the utility.

Preferences Just Got Harder to Prove

Ordinary Course Defense. Creditor defendants relying on the ordinary course of business defense will now only have to show that the payment was consistent with *either* (i) the payment history between the debtor and the creditor or (ii) industry standards. Creditors will no longer have to prove both of these facts.

Dollar Limit. A trustee or debtor may no longer seek to avoid a preferential transfer of property with a value of less than \$5,000.

Extension for Security Interest Perfection. The Act extends the time when a security interest "transfer" is deemed to occur for preference purposes until (i) the date the security interest is granted, if the interest is perfected within 30 days of the grant, or (ii) the date of perfection, if perfection occurs more than 30 days after the grant.

Purchase Money Security Interest Defense: Longer Grace Period. A creditor perfecting its purchase money security interest now has 30 days (instead of 20 days) after the debtor receives possession of the property.



Deprizio Completely Dead. The Act clarifies that a trustee or debtor may not avoid a transfer that occurred between 90 days and one year to a non-insider that was made for the benefit of an insider creditor. The Act supplements 1994 Code amendments to overrule *Deprizio* which had permitted a debtor to avoid payments to lenders outside of the 90-day preference period when an insider had benefited.

Fraudulent Transfers Expanded

Reachback Period. In cases commenced on or after April 20, 2006, a trustee or debtor may seek to avoid a transfer that occurred up to 2 years before filing (rather than the current 1-year period).

Insider Compensation. In cases commenced on or after April 20, 2005, a trustee or debtor may avoid a transfer to an insider pursuant to an employment contract if it was made outside the ordinary course of business and the debtor received less than reasonably equivalent value. Proof of insolvency is not required.

Commercial Real Estate Leases

Debtor Lessee's Time to Assume or Reject Limited. The debtor lessee now has 120 days (rather than the existing 60 days) to assume or reject commercial leases. However, absent the lessor's consent, this new period may only be extended by a single 90-day period for cause.

Damages for Post-Assumption Rejection. If a debtor assumes and then rejects a commercial real estate lease, the lessor's administrative expense claim is capped at an amount "equal to all monetary obligations, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or actual turnover of the premises, without reduction or offset for any reason, except for sums actually received or to be received" from a non-debtor. Any balance shall be treated as an unsecured claim subject to the damages cap under §502(b)(6).

Dismissal and Conversion

Expanded Grounds for Conversion or Dismissal. The non-exhaustive list of grounds showing "cause" to dismiss or convert a case now includes the following: (i) substantial or continuing losses and absence of reasonable likelihood of rehabilitation; (ii) gross mismanagement; (iii) unauthorized and prejudicial use of cash collateral; (iv) non-compliance with a court order; (v) failure to maintain insurance; (vi) failure to satisfy timely filing or reporting obligations; (vii) failure to attend statutory creditors' meeting; (viii) failure to attend meetings or furnish information to the U.S. Trustee; (ix) failure to pay taxes timely; and (x) failure to file a plan and disclosure statement timely.

Dismissal or Conversion Discretion Limited. The Court must dismiss or convert the case if cause is shown unless the court finds "unusual circumstances" establishing that conversion or dismissal is not in the "best interests of creditors or the estate." If cause is established, the debtor must prove: (i) reasonable likelihood of plan confirmation within the exclusivity period or within a reasonable period of time thereafter; and (ii) its acts or omissions supporting "cause" for conversion or dismissal (a) are reasonably justified; and (b) can be cured within a reasonable time. If the case is not converted or dismissed due to special circumstances, the court must appoint a trustee or an examiner.

Deadline to Hear Conversion Motions. Courts must hear dismissal or conversion motions within 30 days of the motion, and must decide the motion within 15 days of the date the hearing is commenced unless compelling circumstances prevent the court from doing so.

Plan Exclusivity

Extensions Limited. The Debtor may not obtain extensions of its 120 day exclusive period to file a plan beyond 18 months from the date it filed bankruptcy.





Wages, Retention and Severance

Insider Retention and Severance. Retention bonuses to insiders are only permitted if: (i) the payment is essential to retention because the insider has a "bona fide job offer from another business at the same or greater rate of compensation"; (ii) the insider's services are "essential to the survival of the business;" and (iii) either (a) the amount of the payment does not exceed 10 times the amount of the mean of similar payments made to non-management employees for any purpose during the same calendar year, or (b) if there have been no payments to non-management employees, the payment does not exceed 25% of the amount of any similar payment to the insider in the preceding calendar year. Severance bonuses to insiders are only permitted if: (i) the severance program is available to all full-time employees; or (ii) the insider severance payment is not greater than 10 times the mean amount paid to non-management employees during the same year.

No Extraordinary Compensation. Out of the ordinary course of business payments to parties, including officers, managers or consultants hired after the case is commenced, are prohibited unless justified by the facts.

Priority Wage Claims. The cap on priority wage claims is increased from \$4,925 to \$10,000, and the time of accrual is extended from 90 days to 180 days before the bankruptcy filing.

The Act changes numerous other provisions of the Code, including those addressing consumers, small business, municipalities, family farmers, cross-border bankruptcy, and tax amendments.

RECENT CASES

Update on Litigious Rights Case

In our December 2004 issue, we reported on *Regions Bank v. Norris Rader of Lafayette, Inc.*, 879 So.2d 904 (La. App. 3 Cir. 7/14/04) where the Louisiana Third Circuit Court of Appeal remanded the case to the trial court for the limited purpose of deciding whether an assignment of a judgment on a note constituted a sale of a litigious right and, if so, the amount necessary for the defendant to redeem that right. On appeal after remand, the Louisiana Third Circuit Court of Appeal has issued another opinion further addressing the consequences of Louisiana's sale of litigious rights law to buyers of disputed debt.

In *Regions Bank v. Norris P. Rader Of Lafayette, Inc.*, 904 So.2d 76 (La. App. 3 Cir. 5/25/05), a bank filed suit against makers of promissory notes and guarantors seeking a money judgment and recognition of its security interests. The bank obtained a default judgment against all of the defendants except two guarantors, against whom it obtained a summary judgment for \$3 million. After the guarantors appealed the summary judgment, the bank assigned the judgments and related rights to a third party for a price of \$1.4 million. The appellate court then remanded the matter to the district court to determine whether the assignment was a sale of a litigious right and, if so, the amount required to redeem the judgment. The district court ruled that the assignment was of a litigious right, established the redemption price at \$200,000 for each of the guarantors and allowed the holder of the judgment to liquidate the collateral.

On the second appeal, the Louisiana Third Circuit found that when a debt holder assigns its rights to another, Louisiana Civil Code article 2652 entitles the debtor to extinguish its obligation by paying the price received by the assignor. The Third Circuit rejected the guarantors' argument that their payment of the redemption price would release the collateral. The Third Circuit recognized that unlike the summary judgments against the guarantors which were on appeal at the time of the assignment, the default judgments against the other defendants were not litigious rights. Thus, there was no basis to release the collateral securing those





obligations. The Court did not address how the \$200,000 redemption price was established by the district court.

Loss of Mortgage by Prescription of Collateral Mortgage Note

In *Joshua Investment Corp. v. Home Sales Counseling, Inc.*, 892 So.2d 151 (La. App. 2 Cir. 1/19/05), purchasers of property at a tax sale sought to cancel a mortgage on the property because the collateral mortgage note had prescribed. Both the hand note and the collateral mortgage note were due on demand and subject to a 5 year prescriptive period. No payments had been made on the hand note for more than 5 years and the notes did not contain a written continuous acknowledgement of the debt.

While the court recognized that the continuous pledge of the collateral mortgage note serves to interrupt prescription of the underlying indebtedness evidenced by the hand note, the court found that the collateral mortgage note had prescribed. The Court held that the prescription of the collateral mortgage note extinguished the mortgage.

Act of Subordination Deficiencies Not a Big Deal

In *Bankers Trust Company of California, N.A. v. Verdin*, 900 So.2d 980 (La. App. 5 Cir. 3/29/05), a second mortgagee filed an executory process action to foreclose on its mortgage. The first mortgagee intervened and claimed the subordination of its note to the second mortgagee was ineffective because the act of subordination contained erroneous recordation information regarding the mortgage to be subordinated and did not contain "Ne Varietur" language. The court found that no Louisiana statute or jurisprudence requires an act of subordination to be in any particular form. The court held that a subordination agreement is enforceable if the parties' intent can be ascertained.

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This publication and the information herein is not legal advice and is not intended to serve as a substitute for consultation with an attorney. Specific legal issues and concerns require the advice of an attorney.

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