

## THE LOUISIANA LENDER LETTER

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### BANK ORDERED TO PAY ON LETTER OF CREDIT FOR FAILING TO TIMELY DISHONOR

This Fifth Circuit case reflects the importance of financial institutions timely dishonoring a request to draw on a letter of credit. In *LaBarge Pipe & Steel Co. v. First Bank*, No. 07-30441, 2008 WL 4967070 (5th Cir. 11/24/08), the beneficiary of a standby letter of credit sued the issuer-bank for refusing to honor the beneficiary's presentation under a letter of credit. The beneficiary submitted a faxed copy of the letter of credit even though the letter of credit required presentment of the "original Irrevocable Letter of Credit." The issuer-bank refused to honor the letter of credit on the basis that the facsimile did not qualify as the "original." The District Court agreed and deemed the defect fatal to the beneficiary's claim. The beneficiary appealed.

The Fifth Circuit agreed that the language of the letter of credit was clear and required the beneficiary to present the "original" letter of credit to the bank when it attempted to draw on the credit. Nevertheless, the Fifth Circuit held in favor of the beneficiary by applying a preclusion contained in Uniform Customs and Practice for Documentary Credits (UCP) 400, Article 16(e). The Court pointed out that under UCP 400, Article 16 and Louisiana's doctrine of strict compliance applicable to the instant transaction, the issuer failed to comply with the UCP when dishonoring the beneficiary's presentation under the letter of credit. The relevant provisions provide that, upon deciding to dishonor a presentment, a letter of credit issuer "must give notice to that effect without delay by telecommunication or, if that is not possible, by other expeditious means . . . to the beneficiary." The issuer received the beneficiary's presentation and waited over three days to inform the beneficiary that it would not honor its presentation. The Court held that the issuer's communications of dishonor cannot be considered notice "without delay" as "they were by no means the shortest reasonably possible interval" and awarded the beneficiary the full amount of its draw on the letter of credit.

### FIFTH CIRCUIT LIMITATION ON EARMARKING DEFENSE TO PREFERENCE ACTION PROVIDES LESSON ON HANDLING PAYOFFS

A troubled debtor finally obtains a new loan to payoff its unsecured debt to you. Think you are in the clear? *Matter of Entringer Bakeries, Inc.*, 548 F.3d 344 (5th Cir. 11/6/08) reflects the problems that can arise if the proceeds of the new loan are not properly handled.

In *Entringer Bakeries*, a lender made a short term bridge loan to the debtor with the expectation that the debtor would obtain permanent SBA-backed financing. The loan was not secured by the debtor's assets but by the guaranty of one of the debtor's principals and the pledge of his personal brokerage account. When the debtor obtained its SBA loan, the debtor deposited the funds into its account and then wrote a check to the lender to pay off the old debt. The debtor filed bankruptcy about six weeks later, and the trustee sued to recover the payment to the lender as a preference under 11 U.S.C. § 547.

The lender defended the claim asserting that the new financing was intended to pay off its debt so that the payment was protected under the earmarking doctrine. Bankruptcy Code section 547 requires a transfer of "an interest of the debtor in property" in order for a payment to be recovered as a preference. Under the earmarking doctrine, a transferee of the debtor's property cannot be liable for a preference where the debtor never had control over the property.

The Fifth Circuit found that the earmarking defense is applicable where the debtor does not obtain control over the funds being transferred. The Court found that the debtor had dispositive control over the loan proceeds once the SBA deposited the funds into the debtor's general account. Accordingly, because the debtor had control over the funds, the earmarking doctrine did not apply regardless of the intent of the parties.

In this case, the lender could have avoided liability if the funds would have been remitted directly to the lender or otherwise placed out of the debtor's control.

## LENDER SANCTIONED AGAIN FOR ASSESSING IMPROPER FEES AND CHARGES

### *Bankruptcy Court Affirmed By District Court*

There are new developments relating to the efforts of the United States Bankruptcy Court for the Eastern District of Louisiana to prohibit the assessment of improper lender fees and charges which we discussed in our July 2008 edition. In *Jones v. Wells Fargo Home Mortgage*, 391 B.R. 577 (E.D. La. 7/1/08), the District Court affirmed most of the decision by the United States Bankruptcy Court for the Eastern District of Louisiana, Judge Magner, in *Jones v. Wells Fargo Home Mortgage*, 366 B.R. 584 (Bankr. E.D. La. 4/13/07).

You may recall that in *Jones* the Bankruptcy Court concluded that the lender charged excessive fees and interest, due in part to the lender's failure to recalibrate its loan after the debtor confirmed his Chapter 13 plan. The Bankruptcy Court ordered the lender to return \$24,450.65 in excessive fees and interest, assessed sanctions of \$67,000, and in lieu of assessing punitive damages, ordered the lender to revise its procedures to ensure that the same mistakes were not repeated. The District Court affirmed all of the Bankruptcy Court's holdings regarding the interest and fees charged by the lender but reversed the Bankruptcy Court's order that the lender implement new accounting procedures. Even though the lender had originally offered to change its procedures in lieu of being assessed punitive damages, the District Court found that the Bankruptcy Court's order equated to injunctive relief without it having considered the requisites for such relief.

### *Same Lender, New Case*

The same home mortgage lender in *Jones*, discussed above, again came under heavy scrutiny by Judge Magner in *In re Stewart*, 391 B.R. 327 (Bankr. E.D. La. 4/10/08). In this case, the debtor paid a monthly mortgage payment a few weeks late, and the lender charged a late fee without notice to the debtor. Each month thereafter, the debtor made his regular mortgage payment which was insufficient because the lender had deducted a late fee from the prior month's regular payment. This pattern continued for over a year with the lender continuing to deduct late fees and other related charges from the debtor's monthly payment without notice. The Court held that the lender breached certain provisions in the mortgage and note by assessing charges without notice to the debtor and by not applying the debtor's monthly payments first to principal and interest rather than fees.

The Court also sharply criticized the lender's numerous charges for inspections and appraisals. The Court found that the debtor's ongoing default created by a single late payment caused the lender's computer system to automatically generate inspection orders and requests for appraisals despite that the debtor was making regular monthly payments. The Court found numerous discrepancies in these reports, many of which were not reviewed by the lender. The Court held that the numerous inspections and appraisals were unreasonable and could not be charged to the loan. Further, although the lender testified that the appraisal charges were simply passed on as third party vendor charges, the Court found that the lender stipulated in another matter that this third party was actually a division of the lender. The Court found that the lender was "illegally" imposing undisclosed fees as third party vendor costs. The Court also found that the lender violated the Bankruptcy Code by charging legal fees incurred during the bankruptcy case without court approval of such fees as reasonable.

In addition to striking numerous fees and costs charged to the loan, the Court assessed more than \$32,000 in damages and sanctions against the lender. The Court further ordered the lender "to audit every proof of claim it has filed in this district in any case pending on or filed after April 13, 2007 and to file amended proofs of claim which comply with the Court's decisions in *Jones* and *Stewart* where necessary.

The Court's decision in *Stewart* is on appeal to the District Court where the lender is seeking a stay of the Bankruptcy Court's order requiring an audit. The request for a stay is currently under advisement by the District Court Judge.

Meanwhile, the United States Bankruptcy Court for the Middle District of Louisiana in *In re Kay Myles*, 395 B.R. 599 (Bankr. M.D. La. 2008) has followed the *Jones* and *Stewart* decisions and imposed sanctions against this same lender for violation of the automatic stay for misapplying a Chapter 13 debtor's plan payments.

### *Tips for Lenders*

*Stewart* provides several lessons for lenders who include fees and other charges in their claims. First, at a hearing on the objection to its claim, a lender must be prepared to provide detailed evidence not only establishing its contractual right to assess the particular fee or charge but also the actual amount incurred for the fee or charge if generated by a third party vendor (such as an appraiser). In connection with multiple property inspection or appraisal fees, the lender should be prepared to explain why the lender thought the multiple inspections or appraisals were necessary. Second, the lender should make sure that the borrower's regular monthly payments are not being applied first to fees and charges if the note and mortgage do not specifically allow for such application. Third, the lender should provide notice to the borrower of all amounts charged to the loan and retain documentation in the file that will enable a lender representative to testify that such notice was provided. Finally, the lender's post-petition legal fees incurred in connection with the bankruptcy case must be approved by the Court as reasonable in order to be charged to the loan.

## FIFTH CIRCUIT FURTHER LIMITS EQUITABLE SUBORDINATION

Many commercial borrowers have threatened to equitably subordinate its secured lender's claim during a bankruptcy proceeding. This bankruptcy remedy allows the debtor's estate to subordinate a senior secured lender's claim to the claims of junior or unsecured lenders in certain circumstances. Although frequently cited, equitable subordination is rarely imposed by courts.

The Fifth Circuit in *In re SI Restructuring, Inc.*, 532 F.3d 355 (5th Cir. 6/20/08) placed another important limitation on equitable subordination. The Court first cited *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 11/21/77) for its own three part test for equitable subordination: (1) the claimant must have engaged in inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code. The Fifth Circuit recognized another limitation on equitable subordination: "a claim should be subordinated only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct."

The Fifth Circuit reversed the Bankruptcy Court and District Court which found that an insider creditor's claim should be equitably subordinated to the claims of unsecured creditors. The Bankruptcy Court found that the insider creditors had breached their fiduciary duties by: (i) presenting the loan transaction to the Board as a *fait accompli*; (ii) securing the loan with the "crown jewel" of the debtor's assets; and (iii) securing their contingent liability as pre-existing guarantors of the debtor's debt. As a result, the Bankruptcy Court held the conduct to be an unfair advantage and ordered the secured claims to be equitably subordinated to the unsecured creditors. The District Court subsequently affirmed.

The Fifth Circuit held that the Bankruptcy Court made no findings that the insider creditors breached any obligations to the debtor or its creditors with respect to one of the loans. With respect to the other loan, the Fifth Circuit held that the Bankruptcy Court made no finding of harm, and that the record did not support a finding that either the debtor or the unsecured creditors were harmed by the loan. The Fifth Circuit rejected an argument that the creditors had been harmed by the debtor's "deepening insolvency."

## DEBT TACITLY REMITTED BY BANK

The Louisiana Court of Appeal for the Second Circuit in *Creditor Recoveries, Inc. v. Crow*, 989 So.2d 233 (La. Ct. App. 2 Cir. 8/13/08) held that a bank tacitly extinguished a debt pursuant to Louisiana Civil Code article 1888 which provides that remission of a debt may be express or tacit. The bank issued an IRS form 1099-C to the borrower with the form being titled "Cancellation of Indebtedness" and returned three 1994 payments to the borrower with a cover letter that termed the disbursements as "over payments." The Court explained that the note was no longer enforceable as these actions evidenced cancellation of the debt by the bank.

## EFTA DOES NOT COMPLETELY PREEMPT STATE LAW CLAIMS

In *Bernhardt v. Whitney National Bank*, 523 F.3d 546 (5th Cir. 4/2/08), plaintiffs filed a state court negligence action against two banks arising out of the use of one of the bank's online banking system to make unauthorized electronic transfers from the plaintiffs' checking account at the other bank. The banks removed the action to federal court on the basis of federal question jurisdiction pursuant to the Electronic Fund Transfers Act, 15 U.S.C. § 1693 et. seq. ("EFTA"). The Fifth Circuit held that the EFTA does not completely preempt state law claims relating to electronic fund transfers and did not, therefore, provide federal question jurisdiction over the plaintiffs' claims in the instant case. The Court explained that the clear language of the EFTA indicates that Congress did not intend for the Act to provide the exclusive cause of action for claims relating to unauthorized electronic funds transfers.

## LOUISIANA SUPREME COURT REVERSES DEPOSITARY BANK'S LIABILITY FOR CONVERSION FOR PAYMENT

In our July 2008 edition, we reported on *Schulinkamp v. Carter*, 984 So.2d 795 (La. Ct. App. 1st Cir. 2/20/08), where the Louisiana Court of Appeal for the First Circuit held a depository bank and a depositor solidarily liable to the named payee for conversion under La. Rev. Stat. Ann § 10:3-420. On the depository bank's writ of certiorari to the Louisiana Supreme Court, the Court reversed the First Circuit without opinion and remanded the case for further proceedings. *Schulinkamp v. Carter*, 992 So.2d 973 (La. 9/26/08). We will report any further developments.

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## ABOUT LEMLE & KELLEHER, L.L.P.

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