

LAW UPDATE

Ruskin Moscou Faltischek's Financial Services, Banking & Bankruptcy Services:

- Commercial Loan Transactions
- Distressed Asset Management
- Loan Workouts and Bankruptcy
- Intercreditor, Subordination, Co-Factoring and Re-Factoring Agreements
- Debtor-in-Possession Financing
- Actions for Goods Sold and Delivered
- Actions on Guarantees
- Actions to Recover Personal and Real Property
- Preference Action Litigation
- Defense of Lenders Against Equitable
- Subordination, Fraudulent Conveyance and RICO Claims
- Intercreditor Dispute Litigation
- Acquisitions of Assets through the Bankruptcy Process
- Bankruptcy Alternative Solutions
- Bank Regulatory and Compliance Matters

Inside Update

- 3 A Seller's Right to Reclaim Under the Recently Enacted Bankruptcy Law
- 4 Establishing Priority of "Purchase Money Security Interests"

Securing Landlord's Interests Through Letters of Credit

by Jeffrey A. Wurst



Jeffrey A. Wurst

A landlord enters into a thirty-year lease with a tenant. After five years, the tenant's business experiences financial trouble and files for protection under Chapter 11 of the Bankruptcy Code. As part of the reorganization proceedings, the tenant rejects the lease. What are the landlord's damages and how can the landlord maximize its recovery?

Any analysis of this issue must start out with the basic tenet that a landlord in this situation has a duty to mitigate any damages that the rejection of the lease causes. For the sake of this discussion, however, let us assume that the landlord is unable to secure another tenant for the remainder of the term. Can the landlord now recover the value of twenty-five years of rent?

In short, the answer is no – in this scenario, the maximum amount that the landlord can claim, pursuant to Section 502(b)(6) of the Bankruptcy Code, is three years of rent. Section 502(b)(6) provides, in pertinent part, that a lessor's claim for damages resulting from the termination of a lease of real property is precluded to the extent that the claim exceeds the greater of: (a) one year of rent; or (b) fifteen percent of the remaining lease term, not to exceed three years. In the above example, the remaining lease term is twenty-five years. Fifteen percent of this is three and three-quarter years. Therefore, the lessor is limited to the statutory maximum claim equal to three years of rent for its damages from the rejection of its lease.

This claim however is not a *recovery* inasmuch as it is merely a claim. And a general unsecured claim at that! In other words, if the debtor's plan of reorganization (or the trustee's distribution) provides for a thirty percent distribution, the landlord's recovery will be a bit over one year of rent. Let's apply this to hypothetical numbers. Assume in the above example that the rent is fixed at \$10,000 per month and the landlord is unable to obtain a new tenant to mitigate its damages. The claim would be set at \$360,000 (36 months at \$10,000). The thirty percent distribution would result in a distribution of \$108,000.

Notwithstanding this cap on damages, a landlord can insulate itself if it requires its tenant to provide cash or a letter of credit as security. The cash or letter of credit would first be applied against the gross claim (\$360,000) and the balance thereafter would be the net claim against which a distribution would be made. For example, if the cash security deposit were in the amount of \$50,000, the landlord would recover \$50,000 and have a claim for the balance in the amount of \$310,000.

Continued on Page 2

From the Editor's Corner



Karen J. DeSalvo

The RMF Financial Services Update is designed to give you an overview of important topics facing the business and lending communities today. To continue to keep clients and friends of Ruskin Moscou

Faltishek apprised of major issues regarding the Financial Services business climate, we bring you the latest edition of the Financial Services Update. This issue contains articles on "A Seller's Right to Reclaim Under the Recently Enacted Bankruptcy Law," "Securing Landlord's Interests through Letters of Credit" and "Establishing Priority of Purchase Money Security Interests."

This issue provides important information on the Bankruptcy Abuse Prevention and Consumer Protection Act that was enacted into law on April 20, 2005. It also provides useful information regarding the benefits of using letters of credit in lieu of cash security deposits in real estate leasing transactions. Finally, this issue outlines basic perfection and priority rules associated with purchase money security interests. We encourage you to email us with your questions so we can devote future articles to issues you deem critical in your field. I hope to hear from you soon at kdesalvo@rmfpc.com

Karen J. DeSalvo is a partner and member of the Financial Services Department and chair of the Commercial Lending Practice Group. She can be reached at kdesalvo@rmfpc.com or 516-663-6585.

Continued from page 1

Thus, the thirty percent distribution would be \$93,000 in addition to the \$50,000, for a total of \$143,000.

Unfortunately, inasmuch as the \$50,000 cash security deposit is deemed to be property of the debtor's estate, the landlord would first need to bring a motion for relief from the automatic stay before it could apply its security deposit against its claim, adding an additional cost to the landlord for the legal expense in prosecuting such a motion.

A letter of credit given to the landlord as security for the tenant's obligations, however, is not deemed to be property of the debtor's estate. A letter of credit is a commitment by the issuing bank to make a payment for the purpose of supporting a commercial transaction. When a landlord accepts a letter of credit in lieu of a cash deposit, the risk of a lessee's nonperformance or insolvency is transferred from the lessee to a bank to the extent of the amount of the letter of credit.

The structure of a letter of credit transaction revolves around the issuer, usually a bank, upon whose financial responsibility the strength of the transaction depends. On one end of the transaction is the applicant, who causes the issuance of the letter of credit and agrees to reimburse the issuer for payment of any monies drawn under the letter of credit, usually providing security for this promise. At the other end of the transaction, there is the beneficiary who is able to draw monies under the letter of credit based upon a separate agreement with the applicant. The result of such a structure is that the beneficiary is assured of payment from a stable financial institution and gains confidence in entering into a commercial transaction with the applicant.

The benefit of this structure is that while the automatic stay prohibits the initiation or continuation of all proceedings against the debtor and all attempts to obtain any property of the debtor without prior court approval, a letter of credit beneficiary does not need court approval to draw upon the letter of credit for its compensation. Also, when a letter of credit is issued contemporaneously with a new extension of credit, the creditor beneficiary will not be subject to a preferential attack because the creditor will have given new value in exchange for the benefit of the letter of credit.

Even though it is a third party that is securing the obligation, a letter of credit does not eliminate the statutory cap on a lessor's rejection damages imposed by Section 502(b)(6). In reaching this conclusion, courts have analyzed the function of the letters of credit rather than their form, determining that since the letters of credit were utilized as lease security deposits, they should be treated the same as security deposits.

There may, however, be rare instances where a letter of credit could apply to gross damages, but only if the debtor's estate was not liable for more than the capped amount. Thus, if the issuer was secured by a third party personal guarantee and not the assets of the debtor, then the proceeds of the letter of credit could apply against gross damages.

Although New York courts have not specifically addressed whether a letter of credit eliminates the Section 502(b)(6) limitation of a lessor's rejection damages, New York landlords still have many reasons to prefer using letters of credit instead of a typical security deposit. They are a safer vehicle of protection, backed by a financial institution, are not subject to market volatility, not subject to the automatic stay and, generally, not subject to preferential attacks.

A Seller's Right to Reclaim Under the Recently Enacted Bankruptcy Law

by Harold S. Berzow



Harold S. Berzow

The former bankruptcy law, Section 546, recognized a seller's right to reclaim goods under the common law or state statute. The sale had to be in the ordinary course of business of the seller, the debtor had to be insolvent when it received the goods and the seller had to make written demand within ten days after receipt of the goods by the debtor. However, if

the ten-day period expired after the bankruptcy filing, the seller was given 20 days after receipt to make written demand. The seller had to be able to identify the goods in the possession of the debtor or the debtor's agent. The goods had to be identifiable and in their original condition. The bankruptcy court had the power to order reclamation or payment, provide the seller with an administrative expense claim or grant the seller a lien on other assets belonging to the debtor.

On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act was enacted into law. Several important changes were made to existing law of which every seller must be aware to better protect its rights in a bankruptcy case.

Firstly, Congress put a statutory *imprimatur* on decisional law by declaring that a seller's right to reclaim is subject to the prior rights of a holder of a security interest in the goods or the proceeds thereof. Secondly, the seller's right to reclaim is no longer subject to state law, but is now embodied within the framework of the bankruptcy law. Where before there was a ten-day rule, now goods received within 45 days before the commencement of the case while the debtor was insolvent are subject to reclamation. The seller, however, must still demand reclamation in writing. If the 45 days from receipt of the goods expires during the bankruptcy, the seller is given up to 20 days from the bankruptcy filing to demand reclamation.

The new law goes on to provide more protection for a seller, for even if the seller fails to give written notice of reclamation, the seller may still claim administrative expense status under § 503(b)(9) of the Bankruptcy Code. It appears that Congress eliminated the court's flexibility because the present provision permitting the court either to allow reclamation or an administrative expense claim has been removed. Instead, if the goods are available at the time of the

demand, the seller is entitled to reclaim them. If the goods are unavailable, it is now unclear whether the seller will have a general claim for the price of the goods or an administrative claim. As noted above, the seller may still gain administrative expense status if he fails to send notice for goods received by the insolvent debtor within 20 days of the bankruptcy filing.

The practical effect of these amendments cannot be overlooked. The improvement of a seller's reclamation rights will significantly increase the debtor's need for cash to pay for goods purchased before the filing to the extent not returned. Pre-bankruptcy planning will have to take into account additional cash needs. Lastly, it will create a larger need for cash at confirmation of a plan because Section 1129 of the Code requires that administrative claims be paid in cash at that time unless there is an agreement for different treatment.

Some of these new provisions will have to wait for interpretation by the courts to sort out the legal and practical effects.

Harold S. Berzow is a partner at Ruskin Moscou Faltischek and is chair of the Business Reorganization Practice Group. He is also a member of the Financial Services, Banking and Bankruptcy Department. He can be reached at 516-663-6596 or hberzow@rmfpc.com.

Establishing Priority of "Purchase Money Security Interests"

by Karen J. DeSalvo

Basic priority rules with respect to two perfected secured creditors claiming the same collateral state that priority rightfully dates from the time a filing is first made. Purchase Money Security Interests (PMSI), however, are treated differently and can obtain "super-priority" status. The holder of a properly perfected PMSI can gain priority over a previously existing security interest pursuant to UCC 9-324(a), if the secured party files before, or within twenty days, of the buyer receiving possession of non-inventory collateral.

When a PMSI holder is secured with inventory as collateral, the secured creditor must search the public records and give appropriate written notice to the creditors who have a perfected security interest in the buyer's inventory. The notice must include that the creditor has, or expects to obtain, a

About the Firm

Founded in 1968, Ruskin Moscou Faltischek P.C. has emerged as Long Island’s preeminent law firm. As specialized as we are diverse, we have built cornerstone groups in all of the major practice areas of law, and service a diverse and sophisticated clientele. With more than 60 attorneys, superior knowledge of the law, polished business acumen and proven credentials, Ruskin Moscou Faltischek has earned a reputation for excellence and success. It is this ongoing achievement that makes us an acknowledged leader among our peers and the preferred choice among business leaders.

The strength of Ruskin Moscou Faltischek’s resources greatly enhances what we can accomplish for our clients – to not only solve problems, but to create opportunities. We take pride in going beyond what is expected from most law firms. The invaluable contacts and relationships we have nurtured in the business community and our multidisciplinary approach heighten our value-added services.

Continued from page 3

PMSI in the buyer’s inventory. It must also “reasonably identify” the inventory and it must be received by the creditors within five years before the buyer receives possession of the inventory. Finally, the PMSI holder must perfect its interest before the buyer receives possession of the inventory.

An important fact about the dynamics of a PMSI is that in a conflict between two perfected PMSI holders – where one is the seller and the other is the lender – the seller has priority pursuant to UCC 9-324(g)(i). Therefore, a lender must be aware that a PMSI seller of the collateral will have a priority interest in the collateral even if the lender is the first to file. To protect itself, the lender should enter into an intercreditor agreement with the seller as a condition of making the loan. With respect to PMSI lenders with interests in the same collateral, the UCC resolves the conflict by ranking priority in the order of filing.

UCC § 324 is replete with other rules governing conflicts between a PMSI and other interests, including real estate encumbrances, buyers not in the ordinary course of business and lien creditors, to name a few. The best course of action for sellers and lenders who seek to obtain a PMSI is to ask for the advice and guidance from counsel to best protect their interests.

The *Financial Services Update* is published to provide clients, colleagues and friends of Ruskin Moscou Faltischek, P.C. with information about developments in financial services matters. It is not a substitute for legal advice and should not be construed as imparting legal advice generally or on specific matters.

Copyright © 2006 Ruskin Moscou Faltischek, P.C. All Rights Reserved.

Real Estate Lending
Benjamin Weinstock
Eric C. Rubenstein

Seniors' Housing
Wayne L. Kaplan
Ellen F. Kessler

Mortgage Foreclosure/Lien Law
Joseph R. Harbeson
Adam L. Brower

Commercial and Secured Lending
Karen J. DeSalvo
Leora Ardizzone
Daniel L. McAuliffe

Bank Compliance
Patricia M. Schauback

Bankruptcy/Workouts
Harold S. Berzow
James A. Glass
Michael S. Amato
Matthew V. Spero

Department Chair
Jeffrey A. Wurst

East Tower, 15th Floor
1425 Reckson Plaza, Uniondale, NY 11556-1425
New York City ▲ Uniondale ▲ Hauppauge
516.663.6600 ▲ www.ruskimoscou.com

RUSKIN MOSCOU FALTISCHEK P.C.
RMF
Smart Counsel. Straight Talk.

PRSRST STD
U.S. POSTAGE
PAID
Permit 135
Smithtown, NY