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FINANCIAL SERVICES Update

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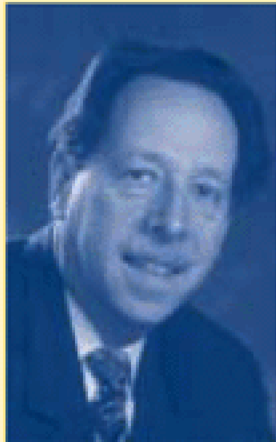
Message from the Chair



Jeffrey A. Wurst

This is a very exciting time for the Financial Services, Banking and Bankruptcy Department at Ruskin Moscou Faltischek. Leading lending institutions continue to turn to RMF for legal representation in documenting transactions and modifications to existing credit facilities, in recovering on defaulted and non-performing loans and in providing counsel when business borrowers file for protection under the Bankruptcy Code. In addition, clients turn to us for advice with their cash flow and insolvency problems. Our department recently successfully completed a *pre-packaged* Chapter 11 bankruptcy and has just commenced another one. This process significantly reduces the cost of bankruptcy reorganization and achieves results in a much shorter period of time.

In order to provide better service to our clients, we have recently established two practice groups within our Financial Services Department. My partner Karen DeSalvo was recently named to head our *Commercial Lending Practice Group.* Harold Berzow has joined our firm as a partner in our department, where he will head our *Business Reorganization Practice Group*. Hal was previously a name partner at Finkel Goldstein Berzow Rosenbloom & Nash in Manhattan. Jim Glass remains of counsel to the firm where he continues to oversee major Chapter 11 bankruptcy cases and other matters. Karen, Hal, Jim and I, together with our associates, remain available to counsel our clients with respect to issues relating to the financial distress of their companies, as well as those of their customers, suppliers and competitors. Please feel free to contact us to set up a meeting to discuss these matters with you.

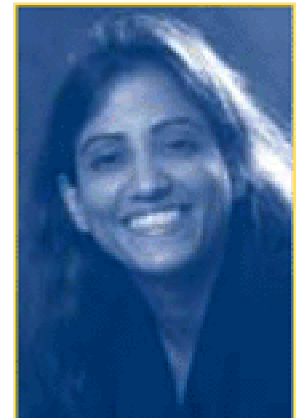
This issue of the *Financial Services Update* contains articles on *The Effects of Bankruptcy on Golden Parachutes* and *Letters of Credit and Rights of Subrogation.* We hope you enjoy it.

LETTERS OF CREDIT AND RIGHTS OF SUBROGATION

By Karen J. DeSalvo and Shalu Rastogi

A recent case in New York involving an issuer of a letter of credit who later brought suit against an individual reflects the availability and expanding extent to which the remedy of subrogation is available to an issuer under Article 5 of the New York Uniform Commercial Code. It also simultaneously leaves intact the "independence principle" that is considered to be the cornerstone of letter of credit law.

Karen J. DeSalvo



Shalu Rastogi

In *JPMorgan Chase Bank v. Cook*, the private banking division of JPMorgan Chase Bank had made a personal loan to Lodwrick Cook, a senior executive at Global Crossing, Ltd., in the amount of $7.5 million. JPMorgan Chase issued an irrevocable standby letter of credit in the full amount of the loan for the benefit of the private banking division, as beneficiary, in case Cook defaulted on his obligations under the loan. The irrevocable standby letter of credit was issued at the request of Global Crossing as part of a benefits package offered to its senior executives. The standby letter of credit was issued under Global Crossing's syndicated revolving credit facility with JPMorgan Chase. Global Crossing was obligated to reimburse JPMorgan Chase for any drawdown on the letter of credit, and Cook was obligated to reimburse Global Crossing for any such payment.

Cook defaulted on the loan and the private banking division drew on the letter of credit issued by JPMorgan Chase. Since Global Crossing had filed bankruptcy, JPMorgan Chase could not look to Global Crossing for reimbursement.

JPMorgan Chase then brought suit against Cook, claiming to be subrogated to the rights of the private banking division of JPMorgan

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EXCELLENCE. PERIOD.

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Letters of Credit and Rights of Subrogation

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Chase against Cook for defaulting on the loan. The District Court agreed and granted summary judgment to JPMorgan Chase against Cook.

In making its decision, the District Court reviewed the doctrine of equitable subrogation. The District Court defined subrogation as the "substitution of one person for another; that is, one person is allowed to stand in the shoes of another and assert that person's rights against the defendant."

While a standby letter of credit resembles a guarantee for another's loan, the majority of courts have held that equitable subrogation does not apply in the letter of credit transaction because of the "independence principal." The independence principal provides that an issuer's obligation to honor a letter of credit is independent of the contract between the applicant and the beneficiary. Because an issuer's obligation under a letter of credit is primary, whereas a guarantor's obligation is secondary, the issuer, "[h]aving paid its own debt, as it has contractually undertaken to do, … 'cannot then step into the shoes of the creditor to seek subrogation, reimbursement or contribution from the [beneficiary's customer].'"

The District Court cited section 5-117(a) of the New York UCC which provides that "[a]n issuer that honors a beneficiary's presentation is subrogated to the rights of the beneficiary to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary" and section 5-117(d) which provides that the rights of subrogation "do not arise until the issuer honors the letter of credit."

The District Court found that the requirements of subrogation were met and that JPMorgan Chase "acted like a secondary obligor (or guarantor) of the underlying obligation."

This case is unique for several reasons. This case is unusual in that it involves an issuer's claim of subrogation to the rights of the beneficiary. The more typical case involves an issuer's rights of subrogation to the rights of its customer, the applicant. It is significant to note that Article 5 of the New York UCC, as revised in 2000, contemplates both scenarios.

The District Court in Cook emphasized that the right to subrogation "does not depend upon contract, but is created simply from the equities of the situation." In the Cook case, "Cook simply never paid back the loan principal to anyone, ever." Had the District Court disallowed JPMorgan Chase from subrogating to the rights of the private banking division, it would have resulted in a gift of $7.5 million to Cook, because "[t]he unforeseen bankruptcy of Global Crossing, the underlying guarantor of Cook's loan, does not change Cook's obligation to repay what he borrowed."

Official Comment 1 to section 5-117 of the New York UCC further indicates that the section does not grant any rights of subrogation, but rather "removes an impediment that some courts have found to subrogation because they conclude that the issuer's or other claimant's rights are "independent of the underlying obligation."

Finally, this case exemplifies why issuers can breathe a little bit easier in New York. Prior to the 2000 revisions to Article 5 of the New York UCC, New York followed the majority rule that because of the "independence principle," subrogation did not apply to an issuer. Normally, it is the issuer that incurs a risk of non-payment should its customer fail to perform its reimbursement obligations, as JPMorgan Chase was exposed due to Global Crossing's bankruptcy. Now, in certain circumstances, an issuer may not necessarily be left holding the bag and may be made whole by stepping into the shoes of a beneficiary or an applicant.

Issuers should be cautioned, however, that the "independence principle" still applies. Under section 5-117(d) of the New York UCC, rights of subrogation do not arise until the issuer honors the letter of credit, and the remedy of equitable subrogation is not available until a claimant has made payment. Therefore, the sanctity of the "independence principle" is upheld and letters of credit remain the reliable and effective payment mechanism that they have been in commerce.

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Financial Q and A

by Karen J. DeSalvo

QUESTION When can a debtor or secondary obligor waive notice of the sale of collateral under Article 9 of the New York Uniform Commercial Code (the UCC)?

Answer Section 9-624 of the UCC provides that a debtor or secondary obligor may waive the right to notification of disposition of collateral only by an agreement to that effect entered into and authenticated after default.

QUESTION When is a secured party's lien on a motor vehicle perfected in New York State?

Answer When a proper application for a certificate of title containing the name and address of the lienholder, the existing certificate of title and the required fee is delivered to the Department of Motor Vehicles.

THE EFFECTS OF BANKRUPTCY ON GOLDEN PARACHUTES

By Michael S. Amato

The "golden parachute" has long been a staple of corporate America. Companies lure bright, intelligent, ambitious business people with employment contracts, which may include such perks as bonuses, stock options and automobile leases. These executives, cognizant of the volatility of the business climate, demand security in the event that the marriage of company and executive ends prior to the expiration of the term of the agreement. Many of these employment contracts provide for substantial cash payments in the event that an executive is terminated other than "for cause," or within a stated time period after a change of control of the company. These golden parachutes have served both company and the executive by allowing the company to obtain qualified personnel and continuity of management, and the executive by providing him or her with economic security when changing jobs or relocating.

However, if the company files for bankruptcy, the benefits and perks of an employment contract may be eviscerated. Recently, the Bankruptcy Court for the Southern District of New York in *In re Applied Theory Corporation, et al.*,[1] held that executives were not entitled to their golden parachutes as provided for in their respective employment contracts.

The Bankruptcy Code provides that certain wages earned prior to the filing of a bankruptcy case (pre-petition) are entitled to "administrative status." The treatment of a claim as an administrative expense may enable a claimant to be paid in full. If a bankruptcy claim is treated as a general unsecured claim, that claimant will only receive a small fraction of their claim.

In *In re Applied Theory*, five executives had employment contracts with the company that entitled them to golden parachute payments ranging from two to four times their annual salaries. These golden parachutes were payable based upon a number of events, including but not limited to: (i) termination by the company without cause; and (ii) in the event an executive was terminated within 12 months of a change of control in the company.

The company filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code. Within a week after the petition date, the company filed a motion in the bankruptcy court seeking approval to sell substantially all of its assets. During the next six weeks, the executives engaged in discussions and/or negotiations with approximately 20 potential purchasers, which efforts resulted in the sale of the company's assets for $20 million more than the initial bids. During this period, each of the executives received their full salary, benefits and perks pursuant to their respective employment agreements.

Michael S. Amato

After the transfer of the company's assets, it discontinued its operations. The court order approving the sale of the assets included the rejection of the executive's employment contracts pursuant to the Bankruptcy Code.

Subsequently, each of the executives filed claims seeking administrative expense priority for their golden parachutes (i.e., full payment of the claims). Their claims aggregated $2.4 million. The executives argued that they were entitled to their golden parachutes under the terms of their employment contracts, or alternatively, that the court could treat their golden parachutes as severance provisions under prior bankruptcy case law.

The Bankruptcy Court rejected the executive's arguments and held that the golden parachute claims should be treated as pre-petition general unsecured claims. The Court stated that the contracts were executed pre-petition, and remained executory on the petition date and therefore, could be rejected by the company in bankruptcy. In addition, the Bankruptcy Court noted that each of the executives were paid their full salary, benefits and perks during the post-petition period and determined that the compensation they received was reasonable compensation for the benefit they provided to the company post-petition.

The Bankruptcy Court did consider its previous decision in *In re Straus-DuParquet.*[2] Since termination in that case occurred post-petition and the payments contemplated were intended to compensate the employees for termination of their employment, the court in *Straus-DuParquet* held that those severance payments were administrative expenses and should be paid in full. The Bankruptcy Court distinguished the golden parachutes because each was required to be paid even if the executives voluntarily chose to leave their positions. Further, the executives were not required to mitigate their damages if terminated without cause, as the payments were

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[1] *In re Applied Theory Corporation, et al.*, 2004 WL 1632837 (Bankr. S.D.N.Y.)

[2] *In re Straus-DuParquet*, 386 F. 2d 649 (2d Circuit, 1967). James D. Glass, Esq., counsel to Ruskin Moscou Faltischek, P.C. was counsel to the debtor in that landmark decision.

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The Effects Of Bankruptcy On Golden Parachutes

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not intended to compensate the executives for termination of their positions. The Bankruptcy Court characterized the golden parachutes as incentives for the executives to remain with the company, distinguishable from a true severance payment which is intended to offset the economic hardship of an individual terminated without cause.

Finally, the Court contemplated the magnitude of the golden parachutes. In *Strous-DuParquet*, the former employees were seeking approximately two weeks of severance. Whereas, *In re Applied Theory*, the five executives were seeking payments totaling $2.4 million. Based upon the extremely high golden parachute payments claims, the Court held that *Strous-DuParquet* did not require it to find that the golden parachute payments were post-petition administrative claims.

The Bankruptcy Court's decision in *In re Applied Theory* has put companies and executives alike on notice that a bankruptcy filing may significantly affect the terms and conditions of employment agreements.

ABOUT THE FIRM

Founded in 1968, Ruskin Moscou Faltischek, P.C. is one of the most respected and largest multi-practice law firms in the New York metropolitan area and is headquartered in Uniondale, New York. With 65 attorneys in 18 practice areas, the firm offers innovative legal services, keeping focus on the client's goals, in the areas of corporate & securities, corporate governance, employment, energy, environmental, financial services, banking & bankruptcy, health law, intellectual property, life sciences, litigation, municipal & regulatory affairs, real estate, construction, seniors' housing, technology, trusts & estates, and white collar crime & investigations. Clients include large and mid-sized corporations, privately held businesses, institutions and individuals.

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

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