

Summary of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

March 31, 2005

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Summary of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005¹

Provisions affecting Business Bankruptcy Cases

Commercial Lease Amendments.

The Bankruptcy Abuse Prevention and Consumer Protection Act (the "Act") imposes new limits on the deadlines in which to assume or reject non-residential real property leases.

- If a debtor fails to assume an unexpired lease of nonresidential real property within 120 days of its bankruptcy filing, the lease is automatically rejected unless the debtor obtains a one time 90-day extension from the court or obtains written consent from the landlord. Section 365(d)(4).

While the Act does adopt numerous landlord friendly provisions, landlords are not left unscathed.

Generally, Trustees do not have to cure nonmonetary defaults that "are impossible to" be cured with compensation unless the landlord experienced an actual and pecuniary loss as a result of such nonmonetary default. The obligation to cure a nonmonetary default due to a failure to operate is required at the time of assumption and thereafter. Sections 365(b)(2); 1124.

- If a debtor rejects an assumed contract, the landlord's administrative claim is limited to the monetary obligations that would have accrued during the two years following the rejection or turnover of the premises. Section 503(b)(7). Furthermore, if the landlord can recover from another source, its administrative claim will be reduced by that amount. If there are damages above the two-year cap, the landlord is entitled to a general unsecured claim for this amount which is thus subject to the Section 502(b)(6) cap.
- Although the Act's creation of Bankruptcy Code Section 503(b)(7) is contained in the "small business" section of the bill, the language appears to cover all bankruptcy cases.

¹ The following summary of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is based on Senate Bill No. 256, as passed by the Senate on March 10, 2005. While it is anticipated that Congress will adopt amendments to the Bankruptcy Code, Senate Bill No. 256 is presently before the House of Representatives as H.R. 685 where it might receive modifications before the amendments to the Bankruptcy Code may be enacted. Accordingly, this summary is intended to show how the Bankruptcy Code will be modified if and when Senate Bill No. 256 is passed by the House of Representatives and signed by the President. This summary is not comprehensive, but is intended to focus on several important provisions. This is simply a summary and all readers should review the applicable provisions of the actual legislation when enacted with counsel to address their specific concerns.

Personal Property Leases.

- If a lease of personal property is rejected or not timely assumed under Section 365(d), the leased property is no longer property of the estate and the stay is automatically terminated. Section 365(p)(1).

When is a preferential transfer not a preference?

- If a transfer is made during the 90 days preceding the debtor's bankruptcy filing on account of a debt incurred in the ordinary course of the debtor's business, the transfer is not recoverable as a preference if the transfer was made in the ordinary course of business **or** made according to ordinary business terms. Section 547(c)(2).
- If a secured lender perfects its security interest within 30 days of the receipt of the property by the debtor, the security interest is within the safe harbor and not a preferential transfer. Section 547(e)(2).
- Transfers to a creditor that total less than \$5,000 are not avoidable as preferential. Section 547(c)(9).

When does the automatic stay apply?

- A creditor cannot be fined for violating the automatic stay unless the debtor has served it with notice of its bankruptcy filing at an address noted in two communications from the creditor within 90 days of the bankruptcy filing or at an address on file with the court. Section 342. While this may provide some protection to creditors, one should expect to see litigation regarding the proper address and whether the creditor actually received notice of the bankruptcy filing.

Plan Exclusivity.

- The Act provides that the 120 day exclusive period in which only the debtor can file a plan cannot be extended beyond 18 months, and the 180 day exclusive solicitation period cannot be extended beyond 20 months. Section 1121(d). Since it often takes considerable time to prepare a plan of reorganization, expect to see an increase in "pre-packaged" bankruptcy filings, and increased pressure in larger cases for the parties to negotiate plan issues.

Reclamation and Special Administrative Expense Claim for Vendors.

- Suppliers can now assert reclamation demands for goods delivered to the debtor within 45 days of the bankruptcy filing, or filing if the 45 days expires after the commencement of the case. Section 546.
 - Even if the creditor is not entitled to reclaim its goods, all goods received by the debtor within 20 days of the bankruptcy filing are entitled to administrative expense priority for the value of the goods sold to the debtor. Section 503(b)(9).
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Under existing law, all administrative claims must be paid in full as a condition to confirming a plan, so this provision will make it more expensive to confirm a plan.

New Professionals.

- In health care bankruptcies, the court is required to appoint an ombudsman to monitor the level of patient care and represent the interests of patients unless the court finds that the appointment is not necessary “under the specific facts of the case.” If an ombudsman is appointed, reports are to be made every 60 days. Section 333.
- If the debtor has a personal privacy policy, the trustee may not sell consumer data inconsistent with such policy. If the debtor seeks to sell personally identifiable information, the court must order the appointment of a consumer privacy ombudsman. The consumer privacy ombudsman is required to assist the court in considering the sale of the personally identifiable information. Section 332.

Possible Supplemental Duties of Investigation under Bankruptcy Rule 9011.

- The Act recommends (but does not require) that the Bankruptcy Rules be amended such that debtors or their attorneys must make a reasonable inquiry to verify that the documents submitted contain accurate information. Since this is only a recommendation, debtors and their attorneys need to make sure they understand the actual requirements of Bankruptcy Rule 9011.

Certain prepetition claims are now given administrative priority if the government is involved.

- If the NLRB obtains a judgment against the debtor for back pay attributable to postpetition work, the award is a postpetition expense even if the unlawful conduct occurred prepetition. If the debtor can establish that this award will substantially increase the probability of layoffs, however, this expense cannot be enforced against the debtor. Section 503(b)(1)(A)(ii).
- A securities self-regulatory organization may enforce its regulatory power, an order or decision (other than for monetary sanctions), delist a company's securities, or refuse to permit the quotation of any stock without fear of violating the automatic stay. Section 362(b)(25).
- Suspension from Medicare is not enjoined by the automatic stay. Section 362(b)(28).
- If a debtor fails to file a tax return, or obtain an extension for a tax return that is due postpetition, the court may dismiss the case. Section 521(j).

Key Employee Retention Programs.

- Debtors will be limited in their ability to provide key employees significant incentives to stay with the company. Section 503(c)(1).
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- First, an employee is not eligible under a Key Employee Retention Plan (“KERP”) unless he/she is essential to the debtor and already has a bona fide job offer.
- Second, even if an employee is eligible to receive a payment under a KERP, the payment cannot exceed 10 times the mean transfer to non-management employees during the calendar year prior to the proposed KERP, or if there were no transfers to non-management employees, the payment cannot be greater than 25% of what the employee could have received during the calendar year preceding the bankruptcy.
- The Act also limits severance payments. In particular, a debtor cannot give an insider a severance payment unless the payment is part of a program generally applicable to all full-time employees and the amount is not greater than 10 times the amount of the mean severance payment made to non-management employees. Section 503(c)(2).

Utility Deposits.

- Section 366 will now require a cash deposit, letter of credit, bond or the like for post-petition services; the debtor can no longer argue that the utility’s right to an administrative claim is enough to provide the required “assurance of payment.”

Disinterestedness; Investment Bankers.

- Section 101(14) no longer provides that investment banks are not “disinterested” because they were/are an investment bank for an outstanding security of the debtor.

Ancillary and Foreign Proceedings.

- Chapter 15 of the Bankruptcy Code will now incorporate the Model Law on Cross-Border Insolvency. As a result, don’t be surprised to see foreign companies utilizing United States Bankruptcy Courts.

Wage Priorities.

- Employees are now entitled to priority claims in the amount of \$10,000 for wages and benefits earned within 180 days of the bankruptcy filing. Section 507(a).

Extension of the One Year Bankruptcy Statute of Limitations for Fraudulent Transfers.

- Trustees can now bring actions to avoid transfers made within two years of the bankruptcy filing. Section 548.
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Avoidance of Insider Compensation.

- The Trustee can also bring an action based on a transfer to insider employees under an employment contract if the transfer was not made the ordinary course of business. Section 548(a).

Ten Year Bankruptcy Planning Reach Back.

- If a debtor transfers property to a trust of which the debtor is a beneficiary within ten years of the bankruptcy filing with the intent to hinder, delay or defraud creditors, the transfer can be avoided. Section 548(e)(1).

Retiree Benefits Modification.

- If a debtor modified its pension plan within 180 days of its bankruptcy filing, while it was insolvent, the court is required to reinstate the old benefits unless the equities favor the new plan. Section 1114(l).

Appointment of a Trustee.

- If the U.S. Trustee reasonably believes that the CEO, CFO or a current officer participated in fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting, the U.S. Trustee is required to move for the appointment of a trustee. Section 1104(e).

Prepackaged Plans.

- Under the Act, if the debtor has a prepackaged plan of reorganization and has already solicited votes, the court may dispense with a meeting of creditors. Section 341(e).

Creditors Committees.

- Section 1102 now provides that the court may order the U.S. Trustee to adjust the number of members and the makeup of committees under § 1102. The provision also indicates that a small business that has a "large" claim – based on the size of the claim as measured against the small business's revenues – can be added to the creditors' committee. Section 1102(a)(4).

Forum for Preference Actions.

- Preference actions to collect consumer debts of less than \$15,000, or any other debt against a noninsider of less than \$10,000 must be brought where the defendant resides. 28 U.S.C. § 1409(b).
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Compensation of Professionals.

- Under Section 330(a)(3)(E), in awarding compensation the court may take into account whether a professional is board certified or has otherwise demonstrated skill and experience in the bankruptcy field.

Disclosure of Affiliate Interests.

- A proposed change to Bankruptcy Rule 9009 will require debtors to disclose the “value, operations, and profitability” of entities in which the debtor holds a controlling or substantial interest through an amendment to the bankruptcy rules. However, the proposed rule does not address what happens if the entity, which is not in bankruptcy and which may not be controlled by the debtor, does not submit such a report or otherwise provide information to the debtor to be able to make such an assessment. Bankruptcy Rule 9009.

Provisions Limited to “Small Business” Bankruptcies

Disclosure Statement and Plan Efficiencies

- A small business bankruptcy case is one in which total debt for the debtor and affiliate debtors is less than \$2 million exclusive of insider debt, and no creditors’ committee is appointed or is determined to be inactive. Section 101(51C).
- In small business bankruptcy cases, the debtor may not need a separate disclosure statement if the court determines that the plan provides adequate information to creditors. Section 1125(a)(1).
- The exclusive period in small business cases is 180 days, and a plan should be filed within 300 days of filing of the case. These deadlines can be extended. Section 1121(e).
- The court is supposed to confirm the plan within 45 days after it is filed. Section 1129(e).

Monthly Reports.

- Under the Act, small business debtors will be required to file periodic reports regarding their profitability, projected cash position, actual cash position, and whether the debtor is complying with its postpetition requirements. Section 308(b).

Financial Reporting by Small Businesses.

- Within 7 days of a “small business” bankruptcy filing, the debtor must file its most recent balance sheets, statement of operations, cash-flow statement, and federal income tax return, or certify that it has not prepared any of these financial records. Section 1116.
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Provisions Purportedly Limited to “Small Business” Bankruptcies.

- The following amendments to the Bankruptcy Code were contained in the “small business” section; however, it appears that they may apply to all cases.

Status Conferences

- Under Section 105(d), the court is required to hold status conferences to further the expeditious and economical resolution of the case.

Convert, Dismiss, Trustee or Examiner

- New Section 1104(a) will permit the court to appoint a trustee or examiner in lieu of converting or dismissing the case if the court determines this to be in the best interests of creditors and the estate.
- Before a case is dismissed or converted, however, a debtor or other party in interest may move the court to deny the dismissal/conversion by establishing that there is a reasonable likelihood that a plan will be timely confirmed. If the debtor is facing a substantial or continuing loss or a diminution of the estate, the court cannot deny dismissal or conversion. Section 1112(b)(1).
- Side Note: The proposed amendment specifically provides that the motion to deny dismissal or conversion may be brought by “the debtor or another party in interest” and does not specifically provide that the trustee or bankruptcy administrator may bring the motion. While this may be a technical oversight, given the Supreme Court’s decision in *Lamie v. United States Trustee*, 540 U.S. 526 (2004), the deletion of the United States Trustee and the bankruptcy administrator from the existing Section 1112(b) could be construed as a Congressional determination that those parties cannot raise the issue of conversion or dismissal of chapter 11 cases.

Single Asset Real Estate Filings.

- Single asset real estate debtors must file a confirmable plan or commence making monthly payments (at the nondefault contract rate) to secured creditors within 90 days of its bankruptcy filing to keep the automatic stay in place. Since it may be difficult to know whether a particular case is a single asset real estate case, the amendment provides that the important date is the later of the 90 day period, or 30 days after the court determines that the debtor’s case is a “single asset real estate” case. Section 362(d)(3).

Provisions Affecting Individual Consumers

The Means Test:

- If an individual’s income for the 6 months preceding his bankruptcy filing exceeds the median income of his state, he will be forced to file a chapter 13 case if the
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debtor can “afford” to repay his creditors \$10,000 over 5 years. If debtor can only “afford” to repay between \$6,000 and \$10,000 over 5 years, conversion is required only if his repayment would represent more than 25% of the nonpriority unsecured claims. Section 707(b).

- How much can a debtor really “afford”? To determine whether a debtor can “afford” a chapter 13 plan, the trustee will compare the debtor’s actual income against an IRS based budget on what the consumer should be spending. If after comparing these budgets, the consumer has extra income, the trustee will then apply the formula to see if a chapter 13 case is proper.

Credit Counseling.

- Before an individual can file for bankruptcy, he or she must receive credit counseling during the preceding 180 days. This requirement can be waived only if the individual can establish that there are exigent circumstances that prevented him from obtaining the required credit counseling. Section 109(h).
- While the debtor is seeking/obtaining credit counseling, the automatic stay does not apply. Accordingly, creditors can take action against the individual’s assets.

Repeat Filers.

- If an individual refiles within one year of his prior bankruptcy, the automatic stay terminates after 30 days unless the court extends the time for the stay.
- If the individual has filed 2 or more cases within the year, there is no automatic stay unless the court orders otherwise. Section 362(c).

Exemptions.

- A debtor must live within a state for 730 days to claim that state’s exemptions. Section 522(b)(3).
- Homestead Exemption: A debtor may not exempt an interest in a homestead acquired within 1215 days of the bankruptcy filing that exceeds the aggregate amount of \$125,000 in real or personal property that the debtor claims as a homestead. Section 527(p).

Pension Liabilities.

- Debts owed to a pension, profit-sharing, stock bonus, or other plan are excepted from discharge. 523(a)(18).

Valuation.

- The value of personal property securing an allowed claim shall be determined based on the replacement value as of the bankruptcy filing. Section 506.
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Retirement Funds.

- Retirement funds, exempt from taxation under section 401, 403, 408, 408A, 414, or 501(a) of the Internal Revenue Code, are not property of the debtor's bankruptcy estate. The amounts exempted shall not exceed \$1 million. Section 522.

Nondischargeable Debts.

- Consumer debts owed to a single creditor aggregating more than \$500 for luxury goods/services purchased within 90 days of the bankruptcy filing are presumptively non-dischargeable. Section 523(a)(2)(C).
- Credit advances to consumers aggregating more than \$750 within 70 days of the bankruptcy filing are presumptively non-dischargeable. Section 523(a)(2)(C).

Residential Leases

- If a landlord has a judgment of possession against a debtor involving residential property, the automatic stay does not prevent the commencement or the continuation of an eviction or ejection proceeding. Section 362(b)(22). However, if nonbankruptcy law would permit the tenant to cure the default, the debtor may stop the landlord's eviction/ejection proceeding by curing the default within 30 days of the bankruptcy filing.

Reaffirmation Agreements.

- If the debtor does not file and perform a reaffirmation agreement with regards to personal property within 45 days of his bankruptcy filing, the automatic stay is lifted. Sections 362(h); 521(a)(6) & (d).

Effective Dates.

Generally, the Act provides that it is not effective until 180 days from the date of enactment and that it does not apply to cases filed before the effective date; some provisions do apply sooner.

- Homestead Exemption Rules: Effective on the date of enactment.
 - Filing Fees: The filing fee changes are effective as of the date of enactment.
 - "Small Business" Reporting Requirements Rules: Effective 60 days after the rules are prescribed.
 - New Judges: The provision providing for additional judgeships is effective on the date of enactment.
 - Wage Priority: The wage priority changes are effective with respect to cases filed on or after the date of enactment.
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- **Fraudulent Transfer Actions:** The two year look-back period for fraudulent transfers only applies in cases filed on or after one year after the date of enactment.
 - **Improper Transfers to Insiders:** The trustee may avoid improper transfers to insiders under an employment contract in cases filed on or after the effective date.
 - **Reinstatement of Retiree Plans:** The provision permitting/requiring the court to reinstate retiree benefit plans is effective in cases filed on or after the effective date.
 - **Debts Relating to Securities Fraud:** Not dischargeable as of the passage of Sarbanes Oxley (July 30, 2002).
 - **Appointment of Trustee in Cases of Fraud:** The provision requiring the U.S. Trustee to move for the appointment of a trustee in cases of fraud is applicable to cases filed on or after the date of enactment.
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