

# Rattet, Pasternak & Gordon Oliver, LLP

## 2005 Bankruptcy Reform Act Bulletin

*On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"). While the Act largely impacts consumer debtors, there are also significant changes enacted that apply to businesses in bankruptcy as well. The following are highlights of some of the changes relevant to businesses.\* The Act will take effect 180 days from enactment and shall apply to cases commenced after that date, although certain provisions are immediately effective.*

### Bankruptcy Tax Provisions

The Act provides federal, state and local taxing authorities new methods by which to enforce the requirements of tax laws and regulations against debtors, and a means to enforce such requirements via the Bankruptcy Court. First, the Act now specifies that the failure to pay taxes or file a tax return constitutes "cause" for dismissal or conversion. The Act also gives a taxing authority standing to request that a Court convert or dismiss a bankruptcy case, for failure to comply with such applicable tax law. In the event that such a request is filed and the debtor fails to file the required return or to obtain an extension during the following 90 days, absent "unusual circumstances" the Court must either dismiss or convert the case, whichever is in the best interests of the creditors. This amendment takes away much of the discretion of the bankruptcy judge to resolve such problems. Finally, the Act codifies the prohibition of a corporate debtor obtaining a discharge from debts arising from specified forms of tax fraud under 11 U.S.C. §1141(d)(6).

The Act has also redefined the method of paying tax claims under a confirmed plan of reorganization. If a debtor intends to provide for a payout over time of tax claims, its plan must provide for regular cash installments that ensure that the taxing authorities obtain payment, the total value of which is equal to the tax claim as of the effective date of the plan. The Act also limits the payout period to a period not to exceed five years from date of filing, and requires that the plan treat tax claims in a manner not less favorable than most favored unsecured nonpriority claims. See 11 U.S.C. §1129(a)(9)(C).

A further tax-related provision of the Act provides that debtors are now required to include in the disclosure statement a discussion of the "potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case..." 11 U.S.C. §1125(a).

### Commercial Real Estate Provisions

The Act's changes to 11 U.S.C. §365, which deals with executory contracts and unexpired leases, will force debtors to make decisions earlier in the bankruptcy proceeding with respect to their real estate interests. The Act extends the initial 60-day period of the old law to assume or reject commercial leases to 120 days, but permits only a single 90-day extension for "cause", where there previously was no limitation on extensions. Further extensions are permitted only if the lessor/landlord consents. Further, an unexpired lease of non-residential real estate will automatically be deemed "rejected" if a debtor fails to file a motion to either assume or reject the lease within 120 days after commencing a Chapter 11 case.

While the Act is rather favorable to lessors of commercial property, there are certain limitations. The Act excuses a debtor/tenant from curing non-monetary defaults that are impossible to cure. However, if the debtor/tenant's non-monetary default is based on a failure to operate under the lease, then (1) the default must be cured by performance at the time of assumption, and (2) the debtor must compensate the lessor for any pecuniary losses resulting from the default.

Another lessee-favorable provision places a cap on damages for post-assumption rejection. If a debtor assumes and later rejects a commercial real estate lease, the Act caps a lessor's ability to recover administrative expenses from the estate pursuant to 11 U.S.C. §503(b). With certain exceptions, under the Act, the administrative priority for such a claim is limited to all monetary obligations due under the lease, for the two years following the later of the rejection date or the date of actual turnover of the leased premises.

### Single Asset Real Estate Cases

The Act has expanded the definition of a "single asset real estate" case by eliminating the cap of \$4 million in secured claims, thereby expanding the scope of this secured creditor friendly statute to larger properties. Also secured creditors are now entitled to relief from the automatic stay to commence foreclosure on the later of the 91<sup>st</sup> day after the case is commenced or 30 days after the court determines that the case qualifies as a "single assets real estate case", *unless* the debtor either (1) makes monthly payments in an amount equal to interest at the then applicable non-default contract rate of interest on value of the collateral, or (2) files a confirmable plan. Such monthly payments can be made from rents and/or other proceeds generated by the property.

Lenders now have heightened protection from abusive and/or bad faith bankruptcy filings which are motivated by underlying real estate issues or disputes. Pursuant to 11 U.S.C. §362(d)(4), lenders are entitled to relief from the automatic stay in order to commence foreclosure if bankruptcy case was commenced as part of a "scheme to delay, hinder, and defraud creditors" and involves either (1) a transfer of property ownership without the consent of the lender or the court, or (2) multiple bankruptcy filings affecting the same property. In this case, a court order, rendered in response to a lender's motion, would be effective for two (2) years and would apply in subsequent cases, provided such order is filed in with the appropriate real estate records.

### Exclusivity Periods

The Act changes the periods within which the Debtor has the exclusive right to file a plan of reorganization and solicit acceptances and rejections to its plan. Under the old law, a Debtor had 120 days and 180 days within which to file a Plan and seek acceptances/rejections, respectively, which periods could be extended for "cause". The Act limits extensions to eighteen (18) months and twenty (20) months, respectively.

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## Preferences

The Act has relaxed the “ordinary course of business” defense available to creditor defendants under 11 U.S.C. §547(c)(2), requiring that a creditor defending a preference action need only show that the payment from the debtor was consistent with (1) the payment history between the debtor and creditor, or (2) industry standards. The creditor no longer has to satisfy both prongs of the defense.

The Act will also make it harder for a debtor-in-possession or a trustee to pursue de minimis actions. 28 U.S.C. §1409(b) provides that for actions to recover less than \$10,000 against non-insiders, a debtor or trustee may only commence proceedings in the judicial district where the defendant resides. Also, small preference claims under \$5,000 are no longer avoidable pursuant to 11 U.S.C. §547(c)(9). This protects potential defendants from the expense of defending such nuisance cases and the estate from the financial drain of litigating such cases.

The Act extends the time when a security interest “transfer” is deemed to occur for preference purposes until (1) the date security interest is granted, if the interest is perfected within 30 days of the grant, or (2) the date of perfection, if perfection occurs more than 30 days after the grant. Moreover, under the Act, the “purchase money security interest” defense is granted a longer grace period. The granting of such a security interest is voidable as a preference provided that perfection occurs within 30 days after the debtor receives possession of goods.

Lastly, the Act supplements the 1994 Code amendments to overrule the decision in *In re Deprizio*, that permitted a trustee to avoid payments to lenders outside the 90-day preference period when an insider/guarantor had benefited. The Act now limits the trustee’s avoidance powers to seek recovery only from the insider and not from the transferee. 11 U.S.C. §547(i).

## Fraudulent Transfers

The Act extends the current one (1) year reachback period for fraudulent transfers to two (2) years pursuant to 11 U.S.C. §548(a)(1). Also, the Act enables a trustee to avoid an insider transfer pursuant to an employment contract if it was made outside the ordinary course of business and the debtor received less than reasonably equivalent value. Prior to the enactment of the Act, a trustee would have to establish that the debtor was insolvent at the time of the alleged transfer in order to avoid the transfer. Now, no proof of insolvency is required. By this amendment, the Act will increase the power of the bankruptcy trustee to investigate dubious executive compensation packages out of the ordinary course of the debtor’s business during the two-year period preceding the filing of a bankruptcy.

## Reclamation of Goods

Under new Section 546(c)(1), a Seller may reclaim good sold in the ordinary course of business if the Debtor received the goods while insolvent, within 45 days of the petition date if the seller demands reclamation (within 45 days of the date of receipt; or (2) not later than 20 days after the Filing Date if the 45 day period expired.

Notwithstanding, a Seller of goods, even if it fails to demand a reclamation in writing provided for above, may assert an administrative expense pursuant to Section 503(b)(9) for the value of any goods received in the ordinary course within 20 days of the filing date.

## Expanded Grounds for Conversion or Dismissal

The Act has significantly expanded and clarified the non-exhaustive list of grounds constituting “cause” for conversion or dismissal of a bankruptcy case. The amended 11 U.S.C. §1112 specifies more of the events or acts constituting the required “cause”, including but not limited to failure to maintain appropriate insurance and failure to comply with reporting requirements of the Bankruptcy Code. These additional enumerated grounds clarify the often litigated topic of what can constitute the amorphous “cause” to convert or dismiss a case. The Act also provides that the enumerated grounds also constitute “cause” for the appointment of an examiner or trustee, and the Act requires the US Trustee to seek appointment of an examiner or Chapter 11 operating trustee for certain of these grounds.

## New Priorities

The Act also provides for a reordering of the types of claims entitled to priority under the Code, as well as modifying the scope of such priorities. Significantly, the new Section 507 increases the priority amount of wage claims to \$10,000 per person for wages, commissions and the like, and doubles the time frame for the earning of such wages earned from ninety (90) to one hundred eighty (180) days prior to the bankruptcy filing. A similarly changed priority applies to contributions to employee benefit plans. The effect of these changes is to increase the protection of employees of a debtor, while also increasing the cost of exiting bankruptcy.

## International Bankruptcy Proceedings

The Act adds a new Chapter 15 to the Code, dealing with the ever-increasing topic of cross-border insolvencies. New Chapter 15 significantly supplements the old Section 304, which left determination on such important topics as recognition of foreign bankruptcy cases, foreclosures, receiverships and cooperation with foreign insolvency tribunals to the doctrine of comity and to judicial discretion.

*Rattet, Pasternak & Gordon Oliver, LLP (“RPGO”) is an “AV rated” boutique bankruptcy firm located in Harrison, New York. RPGO focuses its practice on corporate reorganization proceedings, workouts, and the debtor-creditor relationship.*

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\*Highlights on changes relevant to consumer bankruptcy to follow in separate bulletin.