

THE CREDIT MEMO

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Bankruptcy Abuse Prevention and Consumer Protection Act

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") was signed by the President into law on April 20, 2005. In addition to the widely reported "means testing" for consumers, the Act contains numerous amendments to the existing Bankruptcy Code affecting business bankruptcies and bankruptcies of "wealthy" individuals.

We highlight below in summary fashion several of the significant changes affecting business bankruptcies - or business creditors in the case of individual bankruptcies. Except where otherwise indicated, the changes will only apply to cases commenced on and after October 17, 2005.

Credit Transactions

Increased Protection from Preference Actions

- ◆ Preference actions cannot be brought in amounts less than \$5,000, and an action less than \$10,000 must be brought in the district in which the defendant resides.
- ◆ In order to establish an "ordinary course of business" defense, the defendant need only demonstrate that the transfers were ordinary as between the defendant and the debtor or that the transfers were ordinary for the debtor's industry, not both as previously required.

Doing Business on the Brink of Bankruptcy: Expansion of Reclamation Claims and Administrative Priority

- ◆ Previously, a creditor could only receive an administrative priority claim for pre-petition deliveries of

goods if it met the requirements of reclamation under state law, which typically protects shipments made within 10 days of the buyer's insolvency. The Act establishes a single uniform rule that preserves reclamation rights for 45 days after receipt of goods by the debtor so long as a timely written reclamation demand is made.

- ◆ In addition, the Act gives sellers an administrative priority claim for goods sold to the debtor in the ordinary course of business within 20 days before the commencement of the case, whether or not a reclamation demand is made.

Commercial Leases

Deadline to Assume or Reject Leases

- ◆ Presently, the time a tenant has to assume or reject a commercial lease is 60 days from the date the bankruptcy is filed, plus additional periods that the court may grant for cause. Bankruptcy courts have allowed lengthy and multiple extensions of this deadline.
- ◆ Under the Act, a tenant-debtor will have until the earlier of 120 days from the date of filing bankruptcy or the confirmation of a plan to assume or reject a commercial lease, plus a one-time only 90-day extension on approval of the bankruptcy court for cause. Further extensions require the written consent of the landlord.

Rejection Damages for Assumed Lease

- ◆ If a lease is assumed and later rejected, the Act sets the landlord's claim for administrative priority rent

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at two years rent following the date of rejection. Previously, the landlord's administrative claim was believed to be without limit—that is—as determined by the lease and state law.

- ◆ The balance of the landlord's claim is treated as a general unsecured claim subject to the cap provisions of section 502(b)(6), which limits future rent claims to the greater of one year's rent or 15% of the remaining rent reserved under the lease (not to exceed 3 years' rent).

Restrictive Use Clauses

- ◆ Under the present law, so-called "anti-assignment clauses" in leases are unenforceable, meaning that leases can be assumed and assigned without the landlord's consent, so long as the assignee can provide "adequate assurance of future performance." A number of bankruptcy courts have permitted lease assignments where the assignee intends to use the premises for purposes prohibited under the use clause, on the grounds that such restrictive use clauses may be unenforceable as anti assignment clauses.
- ◆ Under the amendments, one small technical change was made to the section rendering anti-assignment clauses unenforceable. The House Report claims that this change makes clear that the assignee is bound by the restrictive use clause in the lease, thereby over-ruling bankruptcy cases that had held to the contrary. Under a close reading of the amendment, however, it is unclear whether it literally has such an effect, and bankruptcy courts will likely continue to disagree over the enforceability of restrictive use clauses.

High Net Worth Individuals

Property Acquired by an Individual Debtor after the Commencement of a Chapter 11 is Property of the Estate

- ◆ Presently, an individual Chapter 11 debtor's post-filing wages and earnings and so-called "after-acquired property" are excluded from the bankruptcy estate and remain property of the individual which he can dispose of without court oversight or authority. Under the Act, all such property, including ordinary wages earned for services rendered after filing bankruptcy, belong to the bankruptcy estate and are subject to bankruptcy court oversight and restrictions on expenditure.
- ◆ This change, coupled with means testing and debt limitations on Chapter 13 relief, may drive individuals, particularly guarantors of failed businesses, into Chapter 11. "Bootstrap" plans, based on the post-petition earning capacity of an individual

debtor, will become more difficult to confirm and more costly to the debtor.

Homestead Protection - New 3 Year 4 Month Rule

- ◆ A homestead is often an individual debtor's most valuable asset, in that the equity in the home may be exempt from creditors and therefore from the bankruptcy estate as provided under applicable state law. For example, in Florida and Texas, the homestead exemption is unlimited in value. Some debtors used these generous state homesteads by acquiring an expensive homestead shortly before filing bankruptcy from assets that were not otherwise exempt. Thus, in an extreme case, an individual with millions of dollars in marketable securities could lawfully evade creditors by liquidating the securities, moving to Florida, and using the money to acquire a multi-million dollar homestead. In other states, homestead exemptions, while not unlimited, may be worth hundreds of thousands of dollars.
- ◆ Under the Act, a debtor may only claim his state's homestead protection if the debtor has owned the home for at least 3 years and 4 months, otherwise the debtor is limited to \$125,000 of his state's homestead exemption. This limitation does not apply to individuals who merely moved from one home to another within the same state, provided the first home qualified.
- ◆ In addition, under the Act, to the extent an individual acquired the homestead within the previous 10 years prior to filing bankruptcy, the homestead exemption must be reduced to the extent it was acquired with non-exempt assets for the purpose of placing them out of the reach of creditors.
- ◆ The homestead provisions become effective immediately - preventing debtors from moving to a more generous homestead state, acquiring a home and then filing for bankruptcy protection and claiming an enhanced homestead objection.
- ◆ The Act imposes a two year residence requirement (extended in certain circumstances) for claiming state law exemptions and caps exempt individual retirement plan assets at \$1,000,000.

Discharge of Property Settlement and Other Divorce Obligations

- ◆ Under current law, an individual debtor cannot discharge alimony and other support obligations undertaken in connection with a divorce decree or settlement. Property settlement obligations, however, are dischargeable, provided the debtor can demonstrate that either he cannot afford the obli-

gations or that the benefit to him in receiving a discharge of such obligations outweighs the detriment to his ex-spouse or dependents. Thus, the discharge of property settlement obligations are currently subject to an equity test by the bankruptcy court.

- ◆ Under the Act, all divorce obligations, including alimony, support and property settlements are automatically excepted from discharge.

Employment Relations

- ◆ The Act creates an exemption from the automatic stay provisions so that a debtor's employer may withhold and collect from a debtor's wages amounts to be used for payments relating to a loan from an ERISA qualified retirement plan or from a qualified thrift savings plan.
- ◆ Employment agreements may give rise to fraudulent transfer claims. Under the Act, payments made to an insider under an employment contract, outside of the debtor's ordinary course of business, may be recovered as a fraudulent conveyance where the debtor received less than reasonably equivalent value in exchange for the payment. The new law makes such payments recoverable, and allows for the avoidance of the employment agreement itself, even if the debtor was doing well financially at the time the employment agreement was executed or the payment made. This change is effective immediately.
- ◆ Changes to retiree health and welfare benefit plans within the six months prior to bankruptcy may be reversed by the Bankruptcy Court unless the Court finds that the balance of the equities favors the modification. This change is effective immediately as to cases commenced on or after April 21, 2005.
- ◆ Employee's wage priority claims have grown from \$4,650 incurred within 90 days of filing to \$10,000 incurred within 180 days of filing.

The Act is the single largest reform of federal bankruptcy laws since enactment of the Bankruptcy Code in 1978, and new and significant developments about these topics will be sure to follow.

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