CREDITORS' COUNSEL CAN'T IGNORE THE BANKRUPTCY BILL

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As most Oregon practitioners are probably aware, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Bankruptcy Bill") (also affectionately referred to by many as "BARF"—Bankruptcy Abuse Reform Fiasco) mainly affects debtors filing petitions under chapters 7 and 13. Creditors' counsel may be breathing a sigh of relief—after all, they do not need to calculate median income or schedule "credit counseling" for their clients. This does not mean creditors' counsel can ignore the Bankruptcy Bill, however. In addition to some debtor-specific provisions that can affect a client (for example new §502(k), which allows a creditor's claim for unsecured consumer debt to be reduced by up to 20% if the creditor fails to agree to an "alternative repayment schedule" proposed by a credit counseling agency), there are also provisions that directly affect creditors. This article highlights some of those provisions. References herein to sections of the current Bankruptcy Code are simply to §___. References to the as yet uncodified Bankruptcy Bill are styled "Bankruptcy Bill §___."

PREFERENCE REFORM

Creditor practitioners have become accustomed to boilerplate preference complaints where the amount demanded is so little and the costs of defense are so high that the only cost-effective option is to settle. One reason for this state of affairs is that arguably the best defense available to creditors—the "ordinary course of business" defense of §547(c)(2)—can be difficult to prove and rarely supports the (relatively) less expensive option of a motion for summary judgment. *See* Charles Jordan Tabb, "Panglossian Preference Paradigm?," 5 *Am. Bankr. Inst. L. Rev*. 407, 418 (Winter 1997) ("many smaller cases simply settle, often splitting the difference, with little regard to the merits of the case"). Section 547(c)(2) currently provides a creditor with a defense to a preference complaint if the creditor proves that the transfer was "(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) made according to ordinary business terms." *In re Kaypro*, 218 F.3d 1070, 1073 (9th Cir. 2000). Under the Bankruptcy Bill, this section will make the defense available if the creditor can prove that the debt was incurred in the ordinary course of business between the debtor and the transferee **and** the payment was **either** made in the ordinary course of business of the debtor and the transferee or was made according to ordinary business terms. Bankruptcy Bill §409.

Another change to preference law has to do with the so-called "DePrizio Problem." In *Levit v. Ingersoll Rand Financial Corporation*, 874 F.2d 1186, 1200-01 (7th Cir. 1989), the court held that the "look back" period for preference recovery was one year, not 90 days, for payments made to creditors which benefited an insider. *DePrizio* involved a so-called "triangular preference" where the debtor construction company made payments to secured lenders on loans that had been guaranteed by insiders. *See* Richard C. Josephson, "The DePrizio Override," 4 *Bus. L. Today* 40 (May/June 1995). The court based its holding on the interplay between then existing §547 and §550. Section 547 allowed the avoidance of payments for the benefit of insiders up to one year prepetition; §550 authorized recovery from the initial transferee—the lender. *DePrizio*, 874 F.2d at 1195-1201.

The Bankruptcy Reform Act of 1994 tried to overturn *DePrizio* by amending §550 to provide that "the trustee may not recover under subsection (a) from a transferee that is not an insider." §550(c)(2). The "DePrizio Fix" worked for the most part. However, a local case, *In re Williams*, 234 BR 801 (Bankr D Or 1999), pointed out the continuing problem. In *Williams*, two debtors had granted a security interest in their mobile home to a lender. The lender perfected within the 90-day preference period. The trustee in the debtors' subsequent bankruptcy tried to avoid the lien. The lender argued that §550 would not allow such a result, because the lender was not an insider. The trustee argued that he did not have to recover anything pursuant to §550, only to avoid the lien under §547. The court agreed. *See* John C. Murray, "DePrizio Lives (in a Mobile Home in Oregon)," 18 *Am. Bankr. Inst. J.* 14 (Oct. 1999).

Amended §547(i) provides:

> If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided

> under this section only with respect to the creditor that is an insider.

Bankruptcy Bill §1213. We can all hope this puts an end to the *DePrizio* problem.

Amended §547(c)(8) also provides that "in a case filed by a debtor whose debts are not primarily consumer debts" (*i.e.*, business bankruptcies) payments cannot be avoided if the "value of all property that constitutes or is affected by such transfer is less than $5,000." Bankruptcy Bill §409.

Section 549, dealing with postpetition "preferences," has been amended to overrule the holding in *In re McConville*, 110 F3d 47 (9th Cir 1997). In *McConville*, a lender without knowledge of a bankruptcy made a postpetition mortgage loan to the debtor. The court held that the "good faith purchaser" provisions of §549(c) did not protect the lender because the granting of a lien on property was not a "transfer of property." *Id*. at 49. Amended §549(c) uses the phrase "transfer of an interest in real property." Bankruptcy Bill §1214.

Finally, the venue rules of 28 USC §1409(b) have been changed to provide that venue in an adversary proceeding seeking to recover a consumer debt of less than $15,000 or a nonconsumer debt of less than $10,000 is appropriate only in the district where the **defendant** resides. Bankruptcy Bill §410. While this may sound good in theory, remember that venue can be waived. Plaintiffs could still theoretically file in the bankruptcy court and wait for a defendant to raise the venue argument.

LEASING ISSUES

Counsel representing nonresidential retail landlords may be pleased to learn that the Bankruptcy Bill has eliminated the seemingly endless motions to extend time to assume or reject leases. Currently under §365(d)(4) nonresidential leases of real property are deemed rejected unless the trustee assumes within 60 days or the court, for cause, extends the 60-day period. This provision has led some debtors to file motions to extend on their petition date. (In the *K-Mart* case, the debtor even tried to extend that time past confirmation.) New §365(d)(4) will make the lease deemed rejected on the earlier of (i) 120 days after the order for relief, or (ii) confirmation of the plan. The debtor will be allowed to extend that time for 90 days, for cause, and any subsequent extensions may be granted only with the prior written consent of the landlord. Bankruptcy Bill §404.

At the recent Northwest Bankruptcy Institute, Professor Klee posited that this provision has the potential to drastically alter the course of retail bankruptcies, with some debtors going so far as to engineer an involuntary petition in order to operate in the gap period, since the 120 days does not begin to run until entry of the order for relief. Most commercial landlords, particularly in a less than stellar economy, are happy to keep the tenant unless they have a replacement tenant or the debtor is not current on its postpetition obligations. Retail landlords get especially very nervous close to the fall back-to-school season and Christmas. Faced with the possibility of a "dark" store during those periods, landlords may be willing to cut a deal on extension. Another possibility is that commercial landlords (and retail landlords in particular) could use their new veto as leverage against some of the more odious debtor tendencies. For example, a landlord could agree to several extensions of time to assume or reject on the condition that, if the lease is rejected, no going-out-of-business sale be held at the store.

Softening the blow to the debtor of §365(d)(4) is amended §502(b)(7), which provides that if a lease is assumed by the debtor and subsequently rejected, the landlord's damages are limited to:

> monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor.

Bankruptcy Bill §445. Any excess balance would be a capped, unsecured §502(b)(6) claim. Prior to this change, if a debtor assumed a lease and then rejected it, the full amount of the landlord's damages over the term of the lease was an administrative priority claim.

A related change addresses nonmonetary defaults. The Ninth Circuit in *In re Claremont Acquisition Corp.*, 113 F3d 1029 (1997), held that debtors could not assume and assign an executory contract because they were unable to cure a nonmonetary default. In *Claremont* the debtors operated automobile dealerships under a franchise agreement. Two weeks before filing for bankruptcy, the debtors closed their dealerships in violation of their franchise agreements. As the Ninth Circuit noted, this event of default is a "'historical fact' and, by definition, cannot be cured." *Id*. at 1033. Debtors' assets were sold and the debtors attempted to assume and assign the franchise agreements. Pointing to current §365(b)(2)(D), the debtors claimed that they could not be required to cure a

nonmonetary default. General Motors ("GM") argued that the section meant debtors could not be required to cure any penalties arising from a nonmonetary default. *Id*. The Ninth Circuit found GM's construction of §365(b)(2)(D) more reasonable, grammatical, and in line with legislative history. *Id*. at 1034. The court therefore held that because the debtors could not cure their failure to operate, they could not assume and assign their franchise agreements. *Id*.

As amended, §365(b)(1)(A) provides that nonmonetary defaults of nonresidential real property leases do not have to be cured:

> if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease.

Bankruptcy Bill §328. The landlord will, however, be entitled to assert "pecuniary losses resulting from such default." *Id*.

Nonmonetary defaults of executory contracts and personal property leases are not treated similarly. Under amended §365(b)(2)(D), *Claremont* is still good law with respect to all executory contracts and leases except real property leases covered by §365(b)(1)(A).

PROTECTION FOR WAREHOUSEMEN'S LIENS

New §546(i) provides that warehouseman's liens cannot be avoided. Bankruptcy Bill §406. Section 546(i)(2) provides that the exception should be applied in a manner consistent with any state statute similar to UCC §7-209. Oregon has codified §7-209 at ORS 77.2090. That section gives a warehouseman a lien against the bailor for goods covered by a warehouse receipt for storage and other charges (except for money advances and interest, which are governed by ORS ch. 79). *See* ORS 77.2090(1), (2). This type of lien requires no filings or statutory notice procedures; it is perfected so long as a proper warehouse receipt has been issued. Note that the warehouseman can also create a so-called "spreading lien" by including statutory language related to "other goods" when the stored goods rotate. For a primer on the requirements for a valid warehouseman's lien, particularly on rotating goods, *see In Re Julien Co.*, 136 BR 765 (Bankr WD Tenn 1992).

EXPANDED RECLAMATION RIGHTS.

The Bankruptcy Bill expands the rights of suppliers of goods to seek reclamation of goods delivered to a debtor during the period before bankruptcy. The amendments also strengthen the position of suppliers with respect to other unsecured creditors. Bankruptcy Bill §1227.

Currently a seller of goods can reclaim goods received by the (insolvent) debtor in the ordinary course within 10 days after receipt of the goods. §546(c). The reclamation claim must be valid under applicable nonbankruptcy law (typically UCC §2-702) **and** the seller must satisfy additional requirements. The UCC has relatively stringent tests for reclaiming goods. For example, the seller must establish that the goods were still held by the debtor in their original form when the reclamation demand was made; or, the reclamation demand must identify the goods sought to be reclaimed with reasonable specificity. Generally, any demand for reclamation is junior and subject to a lien on inventory, cutting off many trade creditors' reclamation claims. Section 546(c) also limits reclamation rights. It provides that in lieu of actually taking back the goods, the court may provide the reclamation creditor with an administrative priority or a lien. Debtors often provide early in their cases that any valid reclamation claims will be given administrative priority, and disputes about whether or not the claim is valid are put off. The result may be litigation over the validity of reclamation claims and compromise of the seller's rights.

The Bankruptcy Bill extends the time period in which a trade creditor can make a demand, thereby expanding the universe of goods that can be reclaimed. The supplier of goods will have 45 days after delivery in the ordinary course to an insolvent debtor to make a reclamation demand. Bankruptcy Bill §1227(a). Also, the requirement that the reclamation claim be valid under the UCC is removed. Suppliers will not have to worry about whether the goods were still in the debtor's possession or in their original form, or whether the demand was made with sufficient particularity. However, the demand is still subject to the prior rights of a secured creditor with a security interest in the goods supplied. *Id*.

The amendments leave some reclamation questions unanswered. Currently, §546(c)(2) specifically provides that if the court denies the creditor the right to physically reclaim the goods, the creditor is to be granted either a lien or an administrative priority. The amendments have stricken this language, making it unclear whether the creditor can **only** retake the goods or whether the court can still grant valid reclamation claims an administrative priority or lien. The amendments **do** provide that reclamation is in addition to the right under §503(b) to

receive an administrative expense priority for goods delivered 20 days prebankruptcy; so presumably, reclamation creditors who supplied goods during this timeframe will receive an administrative priority under both §503 and §546(c). But the remedy for suppliers during the 20 to 45 days prebankruptcy is not clear.

EXPANDED RIGHTS FOR UTILITIES

The Bankruptcy Bill gives utility companies the power to alter, refuse, or discontinue utility service to a debtor without having to obtain relief from the automatic stay or court approval. Bankruptcy Bill §417. As a result of these changes, chapter 11 debtors must work out a mutually agreeable form of assurance within the first 30 days of the case to avoid termination by the utility companies.

Currently, utility companies are barred from discontinuing or altering service to a debtor unless within 20 days after the date of the order for relief, the debtor furnishes "adequate assurance of payment" either in the form of a deposit or other security. §366. Adequate assurance is typically given in the form of an administrative expense priority.

Amended §366 defines the term "assurance of payment." It includes a cash deposit, letter of credit, certificate of deposit, surety bond, prepayment of utility consumption, or another form of security. Bankruptcy Bill §417. The administrative expense priority that utility companies are now given is no longer listed as an acceptable form of adequate assurance. The utility company can alter, refuse or discontinue utility service to a chapter 11 debtor if during the 30 days beginning from the petition date the utility does not receive adequate assurance "satisfactory" to the utility. In deciding whether the assurance of payment is adequate, the court may not consider the absence of security before the petition date, the timely payments by the debtor for service prepeition, or the availability of an administrative expense priority. Further, a utility can offset a security deposit without notice or court order. *Id*.

The Bankruptcy Bill does not require that the utility seek court approval before terminating service in accordance with the new provision, and as amended §366 will arguably eliminate the need to seek relief from the automatic stay before terminating service.

CONCLUSION

This article is intended only to highlight some provisions of the Bankruptcy Bill that may affect creditors. You should refer to the full Bankruptcy Bill or a new edition of the Bankruptcy Code to determine what sections affect your clients.